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Professor of Law, Fordham University School of Law; member of the New Jersey and New York bars. Professor Kessler gratefully acknowledges the permission of Professor F. Hodge O'Neal, the author, and Callaghan & Company, the publisher, for their consent to use material from O'Neal, Close Corporations (1958), an indispensible text for all practitioners dealing with close corporations.

CERTIFICATE OF INCORPORATION FOR A NEW YORK CLOSE CORPORATION: A FORM

*ROBERT A. KESSLER**

"NEVER rely on a form!" Lawyers are often given this advice, and it is good advice. No form can be blindly copied. The lawyer must draft papers for his clients which will be tailor-made to fit their needs. Just as any sensible lawyer recognizes this, he also knows that forms can be of immense help in this task of individual tailoring. At best he may find one, after a long enough search, which will almost exactly fit the needs of his client. At worst, forms suggest matters which the lawyer might not have thought of before but which his document should cover to meet the needs of his client. He may even find a paragraph or a few phrases which he can copy off exactly. It is primarily with this hope of "jogging" the lawyer's imagination, and, perhaps, of supplying at least a few appropriate words that this form is offered.

The form certificate which follows has been drawn up primarily for the close corporation which the ordinary practitioner is most likely to encounter: one which starts off with ten or less shareholders, as a small venture, to which all of the shareholders will devote all of their business time, and from which they hope to derive all (or almost all) of their income, and as a result of the successful operations of which they hope to leave their widows as "well-fixed" as possible. Obviously, even within such a conspect great leeway is possible.

As with any other document involving more than one party, the structure of a close corporation (which will, of course, be determined by its certificate of incorporation and by-laws) will depend on two factors: the relative bargaining positions of the parties involved, and the sagacity of their respective lawyers (or the clients themselves, since in business matters they are often more adept than their counsel).

Thus, in a corporation in which one participant is to put up more than half of the assets, he may want—and the other shareholder(s) may be willing to accede to his demand—complete control. In such a case, the lawyer may rely on the simplest form certificate of incorporation and by-laws. He may buy them already printed and simply fill in the blanks.

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Oddly enough, as a result of accommodations in the statute, the lawyer for a one man corporation will also be able to rely on a printed certificate, although he will probably want to make a number of changes in the form corporate by-laws.

For most close corporations involving two or more participants, the form by-laws are inadequate, *i.e.*, they must be drastically amended, and although a printed certificate may be used, a significant number of additions must be made. One reason is that often, although their financial contributions are unequal, minority participants will be unwilling to accept the simple plutocracy which is the ideal of most corporation statutes. Thus, *e.g.*, one participant may be contributing a patent or "know-how,"[1] difficult to evaluate in monetary terms, but the exploitation of which is the very *raison d'etre* for the venture. Even though the other shareholders are contributing more cash, he may be unwilling to accept the ordinary "money-talks" arrangement, and the people who have only money to offer may also be willing to go along with him on this. In such a case, or, in fact, in any situation where a control arrangement *other* than one in which all power is given to the person who happens to contribute more than one-half of the financial capital is desired, careful drafting is necessary.

Drafting of any instrument where more than one party is involved represents the result of negotiation. This is, of course, also true of incorporation papers, at least where each party is represented by his own attorney. To a certain extent then, the drafting of these documents will be the result of an Hegelian synthesis between two opposing positions. It is, of course, always possible for the lawyer for one party, *e.g.*, the principal financial interest, to insist on the complete control for his side that the ordinary corporate setup would give, while the minority party's attorney is equally intransigent in his insistence upon an absolute veto over all corporate decisions. If each drafts papers in accordance with what he regards as the ideal for his side, a great deal of time and effort will ordinarily be wasted as a result. Clauses giving an undue advantage to one side will be stricken by the other, redrafted by the first, "corrected" again by the other, and after a number of acrimonious sessions, unless the entire deal falls through—possibly with the loss of their respective clients by both lawyers—documents protecting the reasonable demands of both sides will finally be hammered out midway between the two extreme positions. Many lawyers operate in this manner.

Many things can be said in favor of this technique. Sometimes, for

1. See, e.g., Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936).

the reasons already suggested, even an extreme position will win out. Furthermore, you never get more than you ask for initially, and unless a lawyer has "way-out" demands that he is willing to trade, he may get considerably less. On the other hand, unless the opposing lawyer's client is extremely eager for the deal, it is usually a better policy to start with demands which are not too extreme, ones which are closer to those which can be accepted by both sides, *i.e.*, give reasonable protection to the vital interests of both.

This position seems especially advisable in drafting incorporation papers, since often the various participants will not be represented by separate counsel, but will all come to one lawyer to accomplish the task of launching their corporate venture.[2]

The attempt has been made, therefore, in the following form to set up an arrangement which will approximate this golden mean. At the same time, the attempt has also been made to keep the provisions sufficiently flexible to allow for differences in non-vital matters depending on relative bargaining position.

When once a control and financial setup has been arranged, whatever form it takes, it is essential that no participant be able to "pull out," to the disadvantage of the other parties. The certificate has, therefore, also been planned to "freeze" whatever structure has been finally agreed upon so that it cannot be changed without the consent of all parties concerned. This is another one of the postulates on which the certificate is drafted. As an illustration of these principles, the high vote provisions of Articles 6 and 8 can be considered.

It is possible under the New York Business Corporation Law, as it was under the old law, to give a minority shareholder a control over all corporate decisions equal to that of the combined force of the majority, *i.e.*, a veto. This, of course, requires such equal control on both the shareholder and director level, where both of these organs are left with their customary powers. Thus, a provision under section 616 requiring shareholder unanimity, and one under section 709 requiring director unanimity, for the transaction of any business on either level can be used to give such complete control over the corporation to a minority participant as is given to the combined total of the other participants, by the simple expedient of placing appropriate language in the certificate of incorporation. However, since a veto over all corporate action gives such great power to the minority, and correspondingly increases the

2. Although often done, such a procedure seems improper unless full disclosure of the potential conflict and consent of all parties is secured. ABA, Canons of Professional Ethics, Canon 6.

probability of a deadlock (the only resolution for which may be dissolution, an undesirable denouement), a list of fundamental matters on which the majority may be willing to yield a veto, without placing itself completely at the mercy of the minority, but still guaranteeing sufficient protection to the latter from oppression, has been set forth. Of course, as indicated above, where the minority's bargaining position is sufficient, it may extract a veto over all corporate action, to grant which the form can easily be modified. The form also accommodates itself to a middle position whereby more than a mere majority, but less than all, of the shareholders must approve corporate action even though such action does not have the effect of altering the fundamental arrangement. Thus, in a corporation with five equal shareholders, all parties might be willing to allow a decision to be made by four of the five, but not want to be bound by a decision by merely three of the five.[3]

Unless the functions of the board are displaced,[4] it is obvious that in order to "freeze" the control arrangement it is also necessary to guarantee the minority holders a place on the board of directors. This guarantee involves two facets: insuring a minority participant's election to the board, and protecting him from removal once he has been elected. Various methods are possible to accomplish these ends. A requirement of unanimity on the shareholder level, even if all shares are of one class of common stock and the minority holder owns less than half, will help to insure his election even if only the election of directors (rather than all shareholder action) is required to be unanimous, since the minority holder can block election of *any* director unless the other shareholders agree to his election too. Because he can thus block election of a successor, such a requirement also helps to protect him from removal.[5]

Every lawyer, however, desires to make whatever arrangement he sets up as "airtight" as possible. The desired board representation can be made more "airtight" by a shareholder agreement whereby the participants agree to vote for the minority member as a director and to keep him in office as such. A further insurance is to classify the shares of

3. This can be accomplished simply by requiring the affirmative vote of 80% of the shares, and 4/5 of the directors, respectively.

4. This seems possible under N.Y. Bus. Corp. Law § 620(b), but, for reasons discussed elsewhere, reliance upon this provision is avoided here. See Kessler, A Close Corporation Checklist For Drafting the Certificate of Incorporation Under the New York Business Corporation Law, 31 Fordham L. Rev. 323, 326-29 (1962).

5. Failure to elect replacement directors for two successive annual meetings will, however, allow any shareholder entitled to vote for directors to petition for judicial dissolution, any provision in the certificate of incorporation to the contrary notwithstanding. N.Y. Bus. Corp. Law § 1104(c).

stock, with each participant being given his own class (*i.e.*, all shares of it), and each class being given the right to elect its own director, who will then be removable only by that class.[6]

The form certificate also contains these provisions for classification of shares. If used carefully, they will not disqualify the corporation from the "Subchapter S" tax treatment which most close corporations will desire.[7]

Instead of a veto, the participants may want a control proportional to their financial contributions. In the ordinary corporation, *i.e.*, one without any special certificate provisions, it will be remembered that this is impossible, since the majority will have an absolute control over ordinary management operations and, under the Business Corporation Law, as opposed to prior law, over many fundamental changes too.[8] The share classification provisions coupled with an appropriate number of directors to mirror the participations (where the number would not become unwieldy) may be utilized to accomplish such proportional control. Thus, if one participant is to contribute 10,000 dollars and each of the other two is to contribute 5,000 dollars to the enterprise, three classes of stock can be set up with the 10,000 dollars participant's class entitled to elect two directors, and each of the other classes having the right to elect one director.[9] Manifestly, a general unanimity provision should then be omitted, however.

Where the number of directors would become unwieldy, a provision under section 620(b) confiding management to the shareholders can be used instead.[10] If such a provision is used a number of matters covered in the form certificate, *e.g.*, Article 6, can be omitted.

The general purpose of most of the provisions will be obvious, although, undoubtedly, the seasoned practitioner will be able to make

6. Classification in this sense (as opposed to staggered terms for directors, also permitted under N.Y. Bus. Corp. Law § 704) is permitted under N.Y. Bus. Corp. Law § 703(a), if provided for in the certificate of incorporation. Such class directors may only be removed even for cause (i.e., with or without cause) by the class which elects them. N.Y. Bus. Corp. Law § 706(c)(2).

7. Prentice-Hall, Corporation Letter, July 27, 1964, reports that of 1,200,000 corporations studied by the Internal Revenue Service, 106,000 had elected Subchapter S, an increase of 17½% in one year.

8. See Hornstein, Analysis of Business Corporation Law, in McKinney's Business Corporation Law, app. 1, at 463-65 (1963).

9. Four classes with the $10,000 shareholder being given all of the shares of two is also a possibility. This is probably the simplest procedure. Each share of each class can then be absolutely equal in par and all other rights insuring that the corporation will not be disqualified from Subchapter S tax treatment.

10. See, e.g., the form set out in Kessler, Arbitration of Intra-Corporate Disputes Under New York Laws, 19 Arb. J. (n.s.) 85, 95 (1964). But cf. note 4 supra.

improvements in verbiage. Explanations for particular provisions and, in certain instances, alternates are supplied in footnotes to the particular Articles.

The choice of placing so many provisions in the certificate, rather than in the by-laws, deserves some justification. In addition to the provisions required for every corporation, certain of the special close corporation provisions (*e.g.*, the high vote and quorum requirements in Articles 6 and 8, the provision for shareholder election of officers under Article 7, and the special dissolution provisions contained in Article 9, as well, of course, as any provisions authorizing any shares and defining their rights) set out in the form must be included in the certificate or they will be invalid.[11]

It can be argued that all other provisions should be placed in the by-laws instead, to avoid encumbering the certificate. Of course, this could be done. If it is, the attorney should remember to place suitable provisions in the certificate prohibiting amendment of the by-laws, and the certificate as well, except by a vote sufficient to protect the interests of all concerned.[12]

There are, however, certain practical reasons for including the suggested provisions in the certificate rather than merely in the by-laws, even if the by-laws are made as invulnerable to change in significant details as the certificate.

In the first place, the certificate is a contract between the shareholders and the corporation and hence binding on them.[13] Also, being a public document it may constitute constructive notice even as to third parties.[14] In short, limitations and restrictions contained in the certificate are more apt to be enforced than those which are merely contained in the by-laws, a private corporate document.

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11. See notes 25-80 to the Certificate infra.

12. This will be necessary to prevent the insertion of contrary controlling provisions in the certificate which, in the absence of a high vote requirement, only requires a majority shareholder vote for ordinary amendments. See N.Y. Bus. Corp. Law § 803(a); Hornstein, supra note 8.

13. See In the Matter of American Fibre Chair Seat Corp., 241 App. Div. 532, 535, 272 N.Y. Supp. 206, 210 (2d Dep't 1934). It must be conceded that this also applies to valid by-laws. Ibid. See also Weber v. Sidney, 19 App. Div. 2d 494, 244 N.Y.S.2d 228 (1st Dep't 1963), aff'd mem., 14 N.Y.2d 929, 200 N.E.2d 867, 252 N.Y.S.2d 327 (1964).

14. See N. A. Berwin & Co. v. Hewitt Realty Co., 199 App. Div. 453, 455, 191 N.Y. Supp. 817, 819 (1st Dep't 1922), stating that one dealing with a corporation "is charged with the knowledge of the limitations of power therein [in the certificate of incorporation] expressed in dealing with the officers of the corporation." The rule is contra as to mere by-law limitations in the absence of actual notice. See, e.g., Barnard, Phillips Factors, Inc. v. Kaplan Silk Corp., 28 N.Y.S.2d 696 (N.Y. City Ct. 1939), aff'd per curiam, 28 N.Y.S.2d 699 (1st Dep't 1941). See generally 19 C.J.S. Corporations § 997 (1940).

Furthermore, in addition to those expressly required to be set forth there, certain other provisions, *e.g.*, those voiding transfers in violation of the certificate, might be construed as "other rights, preferences and limitations" of the shares and void unless set out in the certificate.[15]

The focus on careful drafting of the certificate may also prevent inadvertent omission and the consequent necessity of later amendment.

Secondly, the certificate, being a higher ranking document, will prevail over possibly conflicting by-law provisions.[16] Although they should be as carefully drafted as the certificate, even printed by-laws (with their typical "Unless otherwise provided in the certificate of incorporation . . .") may not cause trouble if the certificate embodies all important management provisions.

Furthermore, when other than form by-laws are used, there is always the danger that a slightly different but innocent appearing by-law may turn out to be, in the eyes of the court, "improperly restrictive of the discretion or powers of the board" and hence invalid because not included in the certificate.[17]

Of course, provisions apt to change frequently (as, *e.g.*, the value at which shares will be repurchased), despite a unanimity requirement, should be left for the by-laws to avoid the bother and expense of a certificate amendment.[18]

One final point should be mentioned. The draftsman must always be alert to the tax consequences which will follow from any particular language utilized. The attempt has been made to set up the provisions in such a fashion that a "Subchapter S" tax election may be made

15. See N.Y. Bus. Corp. Law §§ 402(a)(5), 501(a).

16. Lasker v. Moreida, 38 Misc. 2d 348, 238, N.Y.S.2d 16 (Sup. Ct. 1963), aff'd mem., 19 App. Div. 2d 862, 245 N.Y.S.2d 994 (2d Dep't 1963).

17. See N.Y. Bus. Corp. Law § 620(b).

18. Other matters, even though vital, should probably also be placed in the by-laws for this reason. For example, the place where shareholder and director meetings will be held should be definitely fixed, probably alternatively at the corporation's place of business and the lawyer's office, to prevent the majority from picking a place where it will be inconvenient or impossible for the minority to attend. Unless otherwise provided in the certificate or by-laws, however, such meetings may be held any place within or even without the state. See N.Y. Bus. Corp. Law § 602(a) (shareholder's meetings: "such place, within or without this state, as may be fixed by or under the by-laws"); N.Y. Bus. Corp. Law § 710 (meetings of the board: "any place within or without this state, unless otherwise provided by the certificate of incorporation or the by-laws"). Because the exact addresses may change, it is simpler to leave them to the by-laws. A certificate provision something like: "All meetings, regular and special, of the shareholders or directors of this corporation shall be held at the Corporation's office within New York State designated in Article 3 of this Certificate," can, of course, be used if this inflexibility poses no obstacle.

should that be desired, and to protect the election against an automatic revocation. (Great care must be used in setting up the classes of shares, however, if they are to be utilized.)[19] The restriction and redemption provisions are also designed to avoid estate tax problems, should the venture prove really successful (or the parties be independently well-to-do).[20] However, the frequent changes in the tax laws, and new regulations thereunder, necessitate a periodic reappraisal of the adequacy of such provisions to secure their purpose.

*CERTIFICATE OF INCORPORATION[1]

of

_____ [2]

UNDER SECTION 402 OF THE
BUSINESS CORPORATION LAW[3]

In behalf of the corporation hereby formed,[4] the undersigned incorporator states:

19. See note 10 to the Certificate infra.

20. The provisions of Article 4, Sections 4 and 6 have been chosen because it was felt they complied with the requirements of Treas. Reg. § 20.2031-2(h) (1958), making the value set in the implementing by-laws binding for federal estate tax purposes.

1. In the following form, matters which must be covered by every certificate of incorporation filed under the Business Corporation Law are marked with an asterisk (*). As to these requirements see N.Y. Bus. Corp. Law § 402(a).

Certain other provisions included herein must be set forth in the certificate of incorporation if the corporation desires to avail itself of them. The notes to the particular provisions indicate which are of this nature. See also Henn, Checklist 3: Certificate of Incorporation, McKinney's Business Corporation Law, app. 4, at 595-99 (1963); Israels, Corporate Practice 136-37 (1963).

In the preparation of this form a number of forms and form books were consulted. Where borrowing has been significant as, e.g., from 2 O'Neal, Close Corporations (1958), appropriate credit has been given. All New York practitioners must, of course, consult Israels, Corporate Practice (1963) and White, New York Corporations (Kantrowitz & Slutsky ed. 1963). Other form books of value are, of course, 3 & 4 Am. Jur. Legal Forms (1953); Casey, Forms of Business Agreements With Tax Ideas (2d ed. 1965); Fletcher, Corporation Forms Annotated (3d ed. 1957); 3 Nichols, Cyclopedia of Legal Forms Annotated (1958); Prentice-Hall, Corporation Forms (1965); Rabkin & Johnson, Current Legal Forms (1964). For the basic requirements of the certificate, Blumberg Form A-234 may be used.

The expression "squeeze-out" is used frequently in the notes to this certificate. It is taken from O'Neal & Derwin, Expulsion or Oppression of Business Associates—"Squeeze-Outs" in Small Enterprises 3 (1961) [hereinafter cited as O'Neal & Derwin], where the term is defined as follows: "By the term 'squeeze-out' is meant the use by some of the owners or participants in a business enterprise of strategic position, inside information,

* ARTICLE 1

The name of the corporation is:[5]

* ARTICLE 2

The purposes for which this corporation is formed are:[6]

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or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants."

As the authors indicate, the term is synonymous with "freeze-out."

Manifestly, once a control arrangement has been agreed upon, no loopholes should be left, whereby one participant or faction will be allowed to upset the arrangement and take unfair advantage of the other members. The guiding principle in the drafting of the following form certificate has been, so far as possible, to plug all such loopholes, so that whatever setup is crystallized will remain indestructible.

2. Name must include "Corporation," "Incorporated," "Limited," "Corp.," "Inc.," or "Ltd." N.Y. Bus. Corp. Law § 301(a)(1). As to prohibited names, and names requiring special approval, see N.Y. Bus. Corp. Law § 301; McKinney's Business Corporation Law § 301, Cross References (1963).

3. This language is mandatory. N.Y. Bus. Corp. Law § 402(a).

4. While corporate existence can probably not begin before filing of the certificate by the department of state, N.Y. Bus. Corp. Law § 403, such language, indicating the formation of the corporation by the execution of the instrument could conceivably result in the court's conferring de facto status in such a situation as that in Tisch Auto Supply Co. v. Nelson, 222 Mich. 196, 192 N.W. 600 (1923), in which the non-filing of the certificate was excusable. A corporation may still have de facto problems. See Lenny Bruce Enterprises, Inc. v. Fantasy Records, Inc., 40 Misc. 2d 715, 243 N.Y.S.2d 789 (Sup. Ct. 1963).

5. The name here must, of course, be identical to that above.

6. As to prohibited purposes, see McKinney's Business Corporation Law § 201, Cross References (1963).

No powers are included, since the statutory powers granted by N.Y. Bus. Corp. Law § 202 are broad, and need not be set forth, N.Y. Bus. Corp. Law § 402(b). As to the inadvisability of setting them forth, see Simon & Davis, The New York Business Corporation Law and the Department of State, 36 St. John's L. Rev. 205, 214-15 (1962).

Other special "powers" often included in certificates of incorporation, e.g., allowing interested and interlocking directors' contracts, exculpation of directors, and indemnification of officers and directors are intentionally omitted, since these are now covered by statutory provisions, N.Y. Bus. Corp. Law §§ 713(a), (b), 717, 721-26, which are exclusive, except that a certificate or by-law provision in effect "at the time of the accrual of the alleged cause of action asseretd in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid" may prohibit or limit such indemnification. N.Y. Bus. Corp. Law § 726(b)(2). Thus, except to limit indemnification, certificate provisions on these subjects are either superfluous as merely repeating the statute, or unacceptable as deviating from it.

The new law is quite generous in providing for indemnification, through an application to the court, even where the corporation does not wish to give it. Thus, it appears that unless the corporation desires to take advantage of the proviso, N.Y. Bus. Corp. Law § 726(b)(2), it may be forced to indemnify a disloyal director or officer for his expenses in a derivative action, or one brought by the corporation itself, where the director

* ARTICLE 3

The city, incorporated village[7] or town and the county within this state in which the office of the corporation is to be located are respectively:

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or officer wins on a technicality like the statute of limitations. N.Y. Bus. Corp. Law §§ 722(a), 725(a). In non-derivative actions, civil or criminal, the director or officer will be entitled not only to his litigation expenses but even the amount of any judgment, fine, or settlement, "if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal proceedings, in addition had no reasonable cause to believe that his conduct was unlawful." N.Y. Bus. Corp. Law §§ 723(a); see N.Y. Bus. Corp. Law § 725(a).

The legislative intention is clear. McKinney's Business Corporation Law § 725, Comment (1963), states, in part:

Its design is to authorize indemnification by judicial action to the full extent, subject to the same standards and qualifications where applicable as in the case of voluntary corporate indemnification. In addition, resort to a court for indemnification is authorized when the corporation has failed to provide for indemnification on a voluntary basis, and even where indemnification has been refused by the directors or shareholders in a specific case. It must be noted, however, that no indemnification can be awarded by a court which would be inconsistent with a corporate provision disallowing indemnification, or otherwise limiting it, in effect at the time of the accrual of the cause of action asserted in the action or proceeding in which the expenses were incurred or other amounts were paid . . . [see N.Y. Bus. Corp. Law § 726(b)(2)].

In a close corporation, actions by or in behalf of the corporation against a director or officer are often merely vehicles for oppression of one of the participants by the others. To prevent such use Article 7, Section 3 in effect forbids the officers to commence any such actions, and Article 6 can, if it is so desired, be moulded to prevent any suit against a participant.

Where a meritorius claim is asserted, however, a director or officer should certainly not both be allowed to escape liability and also receive reimbursement, where for some reason or other the director or officer is not finally "adjudged to have breached his duty to the corporation . . . ." N.Y. Bus. Corp. Law § 722(a).

A provision denying power to the court to indemnify under any circumstances is apparently possible, N.Y. Bus. Corp. Law § 726(b)(2). The following could be used:

In addition to all other limitations otherwise imposed by law, no indemnification shall be made, paid, allowed or advanced to any person made a defendant in any action civil or criminal, against any judgment, fine, amounts paid in settlement, or expenses of any kind, where said person has not been wholly successful on the merits. Nothing herein contained shall prevent the Corporation itself from awarding any indemnification to any person, upon complying with the appropriate provisions of the Business Corporation Law, where such indemnification has also been approved by the directors or shareholders in accordance with Article 6 or 8 of this Certificate.

Since the right of the court to award indemnification is, as indicated above, more limited in actions not brought by or in behalf of the corporation, it might be desirable to deny the right only in the latter type of case. Such a provision as the following might then be used:

In addition to all other limitations otherwise imposed by law, no indemnification shall be made, paid or allowed to any person made a party to an action by or in the right of the Corporation to procure a judgment in its favor by reason of the fact that he, his testator or intestate, is or was a director or officer of the Corporation, against any expenses incurred by him in connection with the defense of such action or any appeal therein, unless such director or officer shall have been wholly successful on the merits and not otherwise.

ARTICLE 4

* *Section 1. Authorized Shares.*—The aggregate number of shares of stock which this corporation shall have authority to issue shall be ..... shares of Common stock (each with a par value of $.....)[8] (divided into three classes as follows: ..... shares of "Class A" Common stock, with a par value of $..... per share, and ..... shares of "Class B" Common stock, with a par value of $..... per share, and ..... shares of "Class C" Common stock, with a par value of $..... per share.[9] The shares of all classes shall be identical in every respect, except that each class, voting as a class, shall have the right to elect members of the board of directors in the same proportion which the number of shares in that class bears to the total number of shares of all classes then outstanding.)[10]

Again, the final sentence of the preceding form might be added to prevent debarring the corporation from awarding indemnification where it chooses to, and the requirements of the statute are met.

Probably the best location for either provision is at the end of the certificate, rather than as part of this article.

7. The attorney should check to make sure the village is incorporated, and not merely the name of a section of a larger municipality.

8. This parenthetical statement is to be used if only one class of common stock is to be issued. It is to be omitted if the common shares are to be divided into different classes, e.g., to help make a shareholders' agreement to elect certain persons as directors more "airtight." See introductory text, pp. 544-45 supra. No provision for no par stock is included, although of course, such stock is permitted, N.Y. Bus. Corp. Law § 402(a)(4), 501(3), since there does not appear to be any advantage to the use of no par over low par stock.

9. Additional classes of common stock may, of course, be added to accommodate additional participants. See, however, note 10 infra.

10. The language in this sentence is used to avoid disqualification of the corporation for "Subchapter S" tax treatment because of the use of different classes of stock. Int. Rev. Code of 1954, § 1371 forbids this special tax treatment if the corporation has more than one class of stock outstanding. Treas. Reg. § 1.1371-1(g) (1959), implementing this section of the statute, provides: "If the outstanding shares of stock of the corporation are not identical with respect to the right and interest which they convey in the control, profits and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation." But the Regulation continues: "However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock." To avoid clever evasions, the section concludes: "If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."

Therefore, it is clear that if the financial participation of each shareholder is equal, the corporation may have a number of classes of Common stock equal to the number

of shareholders, with each class entitled to elect one director, to guarantee each shareholder board representation, so long as the shares of each class are otherwise identical. Thus, in a corporation set up by three persons, each desiring to contribute $5000 to the venture, by use of three classes of Common stock, each class having, e.g., 5000 shares of $1 par value (or 500 shares of $10 par value, etc.), each shareholder getting all the shares of his class, and each class entitled to elect one director, each participant can be guaranteed a place on the board—and under the Business Corporation Law, a place from which he cannot be removed except by judicial action for cause, N.Y. Bus. Corp. Law § 706(c)(2), (d)—and the corporation can still qualify for "Subchapter S" tax treatment. Again, if board representation is to be proportional to shareholdings no problem is posed. Thus, e.g., if one shareholder is to contribute $5000 and the other $10,000, the "Class A" Common for the first shareholder can have half as many shares as the "Class B," of the same par, all of the latter of which will go to the second more prosperous participant, as long as "Class A" elects one director to "Class B"'s two. Because of the form of Article 8, Section 3, however, it is preferable to have three classes each with an equal number of shares and each entitled to elect one director, with the shareholder who contributes the $10,000 being given two classes. For similar reasons, and to insure no "Subchapter S" disqualification, the following language might also be added at the end of the section: "In all other respects, the shares of all classes shall vote as though they were all of one and the same class." See also note 77 infra.

Problems arise where it is desired to give greater board representation than the financial participation would justify.

By careful planning it would seem possible in certain instances to utilize the classification device even where equal board control (i.e., a veto) is desired and the participation is unequal, without disqualifying the corporation for "Subchapter S" treatment. For example, in a two man corporation to which one participant will contribute $10,000 and the other $7500, the stock can be divided into two classes each having 8750 shares, each class entitled to elect one director. The shareholder contributing the $10,000 can be given all of the shares of one class and 1250 of the shares of the other, without interfering with the smaller holder's election of himself to the board. Presumably this division will also not violate the requirement that shares be entitled to elect a number of directors proportional to the shares in each "group," although the Internal Revenue Service does not appear to have ruled on the matter, and the device may, accordingly, be dangerous since the shares might be considered to possess "a difference as to voting rights." If the chance is to be taken in the use of this device, it should be remembered to delete Section 2(A) of Article 8, substituting therefor a requirement of a simple majority (or whatever percentage will still give the minority a guarantee of election of his director) for election and removal of directors (under Article 8, Section 3).

Clearly, preferred stock will disqualify the corporation for "Subchapter S" tax treatment. Furthermore, even for close corporations which do not elect "Subchapter S" treatment, preferred stock, although it may have utility later on for a wealthy participant in a successful enterprise, is ordinarily not ideal for the newly formed venture. Ordinary preferred stock dividends are not deductible by the corporation as business expenses. They are also taxable to the individual recipients as ordinary income subject, of course, to a minor $100 exclusion under Int. Rev. Code of 1954, § 116; the credit is no longer available, since Int. Rev. Code of 1954, ch. 736, § 34, 68A Stat. 13, has been repealed, 78 Stat. 17 (1964), as to dividends received after 1964. There is, therefore, a species of double taxation. Bonds (or some other form of debt security) are, therefore, preferable, from a tax point of view, as a means of guaranteeing an investor a fixed return on his

Section 2. Preemptive Rights.[11]—Each holder of the Common stock of this corporation (of whatever class) shall have the first right to purchase shares (and securities convertible into shares) of Common stock,

money, since, although fully taxable to the recipient as ordinary income, interest payments are at least deductible on the corporation's income tax return. Int. Rev. Code of 1954 § 163; Treas. Reg. § 1.163-1 (1957). For this reason no form for authorizing preferred stock is here set forth.

It should be noted that the certificate may authorize preferred stock without disqualifying the corporation for "Subchapter S." It is only the issuance, or more accurately, the fact that such stock is outstanding which will do so. Treas. Reg. § 1.1371-1(g) (1959). Therefore, a provision authorizing preferred stock "just in case," could be placed in the certificate, even though the shareholders intend to elect "Subchapter S." Since the exact rights and limitations of such stock can vary considerably, it would seem wiser, however, to wait until (if ever) the need arises, and then insert the provisions by amendment, under N.Y. Bus. Corp. Law §§ 801(b)(7), (12), (13), 805.

If, however, preferred stock is to be issued immediately, provisions should be set forth here authorizing issuance of such stock, and setting forth the relative rights, preferences and limitations on such shares. N.Y. Bus. Corp. Law § 402(a)(5). If these shares are to be issued in series, see N.Y. Bus. Corp. Law §§ 402(a)(6), 502. As to possible provisions, see Israels, Corporate Practice 389-96 (1963); 2 O'Neal, Close Corporations §§ 10.04, .05 (1958); as to possible restrictions on dividends to junior shares where cumulative preferred shares are issued, see Baker & Cary, Cases on Corporations 1011-12 (3d ed. unabr. 1958).

If preferred stock is to be issued, Article 10 should be deleted, since "Subchapter S" tax treatment will not be available, and appropriate modifications will have to be made in Section 4 of Article 4, Section 7 of Article 6, Section 4 of Article 7 and in Article 9.

A requirement of an offer of all the shareholder's stock, common and preferred, should be considered, but the offerees should probably be the common stockholders (pro rata) after the corporation.

Certainly, under Article 4, Section 6, the corporation should be required to repurchase all of the shareholder's stock, to enable the holder to take advantage of Int. Rev. Code of 1954, § 302(b)(3).

No certificate authorization for bonds is required unless they are to be given voting rights, N.Y. Bus. Corp. Law §§ 202(a)(7), 518(c), a dangerous procedure from a tax point of view, since such voting bonds may be treated as a class of stock. Treas. Reg. § 1.1371-1(g) (1959); Treas. Reg. § 1.163-1(c) (1957).

It is, as indicated elsewhere, dangerous to authorize more shares than it is presently contemplated will be initially issued. Kessler, A Close Corporation Checklist for Drafting the Certificate of Incorporation under the New York Business Corporation Law, 31 Fordham L. Rev. 323, 331 (1962); see O'Neal & Derwin § 4.14. See also note 11 infra.

If cumulative voting is to be allowed the following provision should be inserted as a separate section after this section:

In all elections of directors of this Corporation, each shareholder shall be entitled to as many votes as shall equal the number of votes which, except for these provisions as to cumulative voting, he would be entitled to cast for the election of directors with respect to his shares multiplied by the number of directors to be elected, and he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them, as he may see fit.

11. Preemptive rights are one means of preventing a "squeeze-out" of a minority shareholder through issuance of additional stock in the corporation. It is obvious that in a two

man corporation, in which each holder has an equal number of shares, e.g., 5000 shares of $1 par, if either holder acquires only one more share he can gain full control of the corporation if no veto provisions protecting the minority appear in the certificate. As indicated below, ordinarily a universal veto will be undesirable, and, therefore, any changes in the number of shares held by a participant may affect, if not upset, the control arrangement of the corporation.

Furthermore, the issuance of any new shares will upset the financial balance in the corporation if it has a surplus in which the new shares are entitled to participate, and these shares are issued merely at par. Thus, in the example, if the corporation has a surplus of $30,000, and 5000 new shares are issued to one holder (or an outsider) the (book) value of the 5000-share-holder's shares automatically goes down from $20,000 to $15,000.

It is important, therefore, to the close corporate setup to prevent the corporate "pie" from being cut up into more pieces through share issuance, whether the new shares are considered in their control or financial aspect, unless the minority's interests are suitably protected.

In order to make such protection "airtight" the following means should all be used: (1) limit the number of shares which may be issued to those really necessary for financing the corporation (see note 10 supra); (2) prevent issuance of any shares, even though authorized, which will result in unfair treatment of the minority, either through dilution of control or financial interest (guaranteed by a veto on the director level in Article 6, Section 9(C)); (3) prevent any increase in the number of shares which may be issued (guaranteed by a veto over amendment of the certificate in Article 8, Section 2(J)); (4) prevent any indirect issuance of additional shares, through options, etc., otherwise possible by the board or a majority of shareholders under N.Y. Bus. Corp. Law § 505 (forbidden by Article 4, Section 3, unless unanimously approved under Article 8, Section 2(K)); (5) guarantee that if any new shares are nonetheless issued the minority will have a chance to preserve their proportionate interest through purchase of sufficient shares to do so, i.e., granting a preemptive right to purchase any new shares issued. Needless to say, however, a preemptive right is of no value if a shareholder does not have sufficient funds to purchase the necessary shares. See Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951).

Preemptive rights are, therefore, one, but not alone a sufficient, weapon in the arsenal necessary to protect (or "freeze") the original power-financial structure.

This section of the certificate is based on a form in 2 O'Neal, Close Corporations § 10.04, at 248 (1958), modified to meet the requirements of New York law. N.Y. Bus. Corp. Law § 622 governs preemptive rights. It generally accords such rights to ordinary common shareholders, unless the certificate of incorporation provides otherwise. However, N.Y. Bus. Corp. Law § 622(e) denies such rights in certain situations. It provides:

(e) Unless otherwise provided in the certificate of incorporation, shares or other securities offered for sale or subjected to rights or options to purchase shall not be subject to preemptive rights if they:

(1) Are to be issued by the board to effect a merger or consolidation or offered or subjected to rights or options for consideration other than cash;

(2) Are to be issued or subjected to rights or options under paragraph (d) of section 505 (Rights and options to purchase shares; issue of rights and options to directors, officers and employees);

(3) Are to be issued to satisfy conversion or option rights theretofore granted by the corporation;

(4) Are treasury shares;

(5) Are part of the shares or other securities of the corporation authorized in its original certificate of incorporation and are issued, sold or optioned within two years from the date of filing such certificate; or

(6) Are to be issued under a plan of reorganization approved in a proceeding under any applicable act of congress relating to reorganization of corporations.

(of whatever class,) of this corporation that may hereafter be issued at any time later than one month after the filing of this Certificate, whether or not presently authorized, and including Treasury shares and shares issued for a consideration other than cash, in the ratio that the total number of shares of (all classes of) Common stock he holds at the time of the issue bears to the total number of shares of Common stock (of all classes) outstanding.[12] This right shall be deemed waived by any holder of Common stock who does not exercise it by paying for the stock preempted within ..... days of receipt of a notice in writing from the Corporation inviting him to exercise the right.[13]

Section 3. Convertible Securities and Stock Options.[14]—This corporation shall not create or issue any securities convertible into stock, nor any rights or options to purchase any shares of its stock or securities convertible into stock, without the approval of its shareholders in accordance with the provisions of Article 8.

Section 4. Restricted Transfer.[15]—No shareholder shall during his

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Shares issued in a bankruptcy reorganization pose no problem. Shares issued in conjunction with a merger or consolidation cannot pose a problem if mergers and consolidations require unanimous shareholder and director consent (see Article 8, Section 2(D), Article 6, Section 9(H)). Shares issued under options, and securities convertible into shares should pose no problem if, as suggested (Article 8, Section 2(K); Article 6, Section 9(D)); they require unanimous shareholder and director approval. The remaining "loopholes" (through issue of stock for other than cash, treasury shares, and shares which are part of those originally authorized), are "plugged" by the language suggested in the section.

12. References to different classes can be omitted if only one class of stock is utilized. Where different classes are used the parentheses should be omitted but the words enclosed therein retained. The parenthetical expression "and securities convertible into shares" should in either case be retained, and in parentheses.

13. Although N.Y. Bus. Corp. Law § 622(g) is somewhat ambiguous on the point, it would appear that any number of days in excess of 14 may be inserted. Clearly, the longer the time given to the shareholder to obtain the money to make the purchase, the more effective will be his preemptive right.

14. This section is designed to prevent dilution of a minority shareholder's interest by such indirect means as convertible bonds, N.Y. Bus. Corp. Law § 519(b), and stock options N.Y. Bus. Corp. Law § 505. See note 11 supra.

15. Sections 4 and 6 of this Article are taken, slightly modified, from Gould, Davis & Hoxie, Stock Purchase Agreements and the Close Corporation 56-57 (National Life Insurance Company, 1960).

Restrictions on inter vivos transfer of shares are necessary to keep a corporation close. Otherwise a key participant could sell (or give) his shares to a person who cannot or will not "pull his oar" by working for the success of the enterprise, or, more likely and worse, he can extort unwarranted concessions from his co-participants by a threat to make such a disposition. Such transfers can—and, accordingly, the threat of their use can be an effective club—also be used to terminate a "Subchapter S" tax election, e.g., by the simple expedient of transferring a portion of his shares to enough persons so that the total number of shareholders exceeds ten, Int. Rev. Code of 1954 §§ 1371(a)(1), 1372(e)(3).

Such restrictions can take various forms. See Henn, Corporations 419, 430-31 (1961); 2 O'Neal, Close Corporations § 7.05 (1958). Although an absolute prohibition on transfer would be invalid, reasonable restrictions are valid, Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957). Giving the corporation (or other shareholders) a first option is, therefore, permissible. Perhaps even requiring the consent of the other participants to any inter vivos transfer would also be valid. See Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc., 256 App. Div. 685, 11 N.Y.S.2d 417 (1st Dep't 1939); Weisner v. 791 Park Ave. Corp., 12 Misc. 2d 774, 177 N.Y.S.2d 887 (Sup. Ct.), rev'd, 7 App. Div. 2d 75, 180 N.Y.S.2d 734 (1st Dep't 1958), rev'd, 6 N.Y.2d 426, 160 N.E.2d 720, 190 N.Y.S.2d 70 (1959). However, because the court of appeals has not yet approved, in other than cooperative-apartment cases, it is not completely safe to rely on such a restriction. See 1910 Ops. Att'y Gen. 404. See generally, as to "consent" restrictions, 18 Am. Jur. 2d Corporations § 385 (1965). Such a provision also places too much power in the hands of the other participants: because they can veto any transfer, they can blackmail any participant to sell at whatever price they choose.

Accordingly, a first option guaranteeing any departing participant a fair return seems the best arrangement—the golden mean which should be acceptable to all participants. If he gets his fair return it makes no difference to him whether the corporation or the other shareholders repurchase his shares. The alternate "cross-option" (repurchase by the shareholders rather than the corporation) is equally acceptable to the remaining shareholders since their proportionate interests remain unchanged. It can be utilized to keep the corporation close even though the corporation lacks a sufficient surplus necessary to make the repurchase itself. N.Y. Bus. Corp. Law § 513(a).

Under the cross-option provision, the only danger of upsetting the proportionality arises if not all shareholers are able to purchase their proper portions. Here, however, it seems better to allow an upset in the balance than to have the shares fall into the hands of outsiders.

The final alternative for an inter vivos offer again prevents the departing shareholder from taking advantage of his co-participants where the value fixed in the by-laws for some reason no longer accurately reflects the market value of the shares. It is a variation on the "best-outside-offer" valuation method.

Although the offer price could be fixed in the certificate it seems better to leave this for by-law determination for two inter-related reasons: (1) the somewhat greater flexibility of the by-laws, since, although they can only be amended by unanimous consent (Article 8, Section 2(I)) to guarantee fairness of the price set to all concerned, amendment can be accomplished without the trouble and expense of a certificate amendment; (2) the necessity for such frequent readjustment in the purchase price to prevent imposition by either the departing or remaining shareholders upon the other.

A fixed price is least likely to give rise to litigation because of differing interpretation, and hence is the most satisfactory valuation method. If the price were set in the certificate, it could, of course, be par or issue price or any other arbitrary figure. The dangers of unfairness of any of these are obvious, since if the business is successful the retiring shareholder is bound to be disadvantaged if the price set is a low one, as it is most apt to be in a new corporation if it is to be at all realistic. On the other hand, setting a deliberately high price would in effect mean utilizing only the "best-outside-offer" option. Since, as will be indicated below, it is best to have a binding agreement to repurchase on death, and, accordingly, some fair method of valuation other than "best-outside-offer" will be advisable there, it is simpler and fairer to have one acceptable method for both inter vivos and death dispositions. A fixed but yearly redetermined value is the one which seems most

lifetime sell, assign, mortgage, hypothecate, transfer, pledge, create a security interest in or lien on, encumber, give, place in trust (voting or other),[16] or otherwise dispose of all or any portion of his stock interest in the Corporation except that if a shareholder should desire to so dispose of any of his stock in the Corporation during his lifetime, he shall first offer to sell all of his stock to the Corporation at a price determined in accordance with the provisions of the by-laws of this Corporation. Any shares not purchased by the Corporation within ..... days after receipt of such offer in writing shall be offered at the same price to the other shareholders, each of whom shall have the right to purchase such portion of the remaining stock offered for sale as the number of shares owned by him at such date shall bear to the total number of shares owned by all the other shareholders excluding the selling shareholder, provided, however, that if any shareholder does not purchase his full proportionate share of the stock, the balance of the stock may be purchased by the other shareholders equally. If the stock is not purchased by the remaining shareholders within ..... days of the receipt of the offer to them, the shareholder desiring to sell his stock may sell it to any other person but shall not sell it without giving the Corporation and the remaining shareholders the right to purchase such remaining stock at the price and on the terms offered to such other person.[17]

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practical and also fairest. Because, then, it will change, the by-laws seem the appropriate place for insertion of the value, and whatever alternative formula is to be used should the shareholders fail to agree on a new valuation within a reasonable time. See Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957), in which the younger shareholder refused to revalue, hoping to acquire the older participant's shares at a bargain price when the latter died.

16. See Gamson v. Robinson, 284 App. Div. 945, 135 N.Y.S.2d 505 (1st Dep't 1954) (memorandum decision); Henn, Corporations 434 (1961); 2 O'Neal, Close Corporations § 28 (1958).

17. "Non-waiver" provisions could be added. They might take the following form:

but in the event of any such transfer to such other person all of the conditions of this Article shall immediately attach to and bind said shares in the hands of the transferee, and the failure to exercise any of the options herein contained shall not relieve said shares or any part thereof permanently from the conditions of this Article, and all of said conditions shall again attach to the shares and bind each successive holder thereof as soon as he acquires them, provided that no person who may hereafter become such a transferee or subsequent transferee shall be entitled to any of the benefits of any of the options contained in this section, except by consent of the shareholders in accordance with Article 8 of this Certificate.

To avoid any question under "Subchapter S" of a difference in rights, the transferee might expressly be accorded, instead, the same rights as the original holder to purchase his proportionate part of any shares not repurchased by the corporation from another retiring shareholder. However, the alternates of first option to the corporation, and then cross-option to the shareholders make so unlikely any transfer to an outsider of the shares

Section 5. Involuntary Transfers.[18]—Any person who becomes the holder or possessor of any shares, or share certificates, of this Corporation by virtue of any judicial process, attachment, bankruptcy, receivership, execution or judicial sale, shall immediately offer all of said shares to the Corporation, whenever requested by the Board of Directors so to do, at the price fixed by the by-laws of this Corporation, and none of

originally issued that such a provision would seem unnecessary. If it were desired to admit a new participant, he could then be made to expressly agree to be bound by any restrictions. If the shares constituted a new issue, e.g., to replace shares redeemed under the corporation's first option, they would seem to be bound directly by virtue of the provisions already set forth in the certificate. See Tomoser v. Kamphausen, 307 N.Y. 797, 121 N.E.2d 622 (1954) (per curiam); Mohawk Nat'l Bank v. Schenectady Bank, 78 Hun 90, 28 N.Y.S. 1100 (Sup. Ct. 1894), aff'd mem., 151 N.Y. 665, 46 N.E. 1149 (1897). See generally Annot., 61 A.L.R.2d 1318 (1958).

18. The likelihood of a creditor of a shareholder getting possession of any shares, or share certificates, has been diminished by the provisions of Article 4, Section 4 which forbid use of the shares as collateral. However, it is always conceivable that the shares might be seized to satisfy some independent debt of the shareholder. To keep the corporation close even in such circumstances, the above provision has been added, modified from Lawson v. Household Fin. Corp., 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930). Although possibly not enforceable, such a provision may help. There appear to be no New York cases directly in point. See, however, Farmers' & Traders' Bank v. Haney, 87 Iowa 101, 54 N.W. 61 (1893), holding that a corporate lien was superior to that of a levying creditor with knowledge of it. See also, Mohawk Nat'l Bank v. Schenectady Bank, 78 Hun 90, 28 N.Y.S. 1100 (Sup. Ct. 1894), aff'd mem., 151 N.Y. 665, 46 N.E. 1149 (1897). In Estate Funds, Inc. v. Burton-Fifth Ave. Corp., 111 N.Y.S.2d 596 (Sup. Ct. 1952), the court held that a pledgee could not foreclose on pledged stock subject to a restriction, without first offering the stock to the other shareholders. But see, Matter of Trilling and Montague, 140 F. Supp. 260 (E.D. Pa. 1956), holding that the trustee in bankruptcy was not bound by a share repurchase agreement, which apparently, however, was not made expressly applicable to involuntary transfers. See also Matter of Starbuck, 251 N.Y. 439, 167 N.E. 580 (1929), which, although holding that a corporation had to transfer shares of a deceased holder to his executrix on its books (despite a statutory provision, N.Y. Stock Corp. Law § 66, N.Y. Sess. Laws 1923, ch. 787, § 66, that the directors might refuse to transfer stock of a shareholder indebted to the corporation), added that it need not recognize a transfer by the executrix. See generally 18 Am. Jur. 2d Corporations § 391 (1965); Annot., 2 A.L.R.2d 745, 754 (1948).

Although the provision could be drafted to require the attaching creditor, etc., to follow the same procedure (first offer to corporation, "cross-option," then "best-outside-offer") as a shareholder voluntarily selling, a provision only requiring an offer to the corporation at the price fixed for repurchase from an ordinary shareholder, which should represent the fair value of the stock, has been deliberately chosen since the fairer and less burdensome the provision is to the outsider the more apt the court is to enforce it. A court desiring to do so can, e.g. point to the fact that a similar provision has been utilized as long ago as 1930, the date of Lawson v. Household Fin. Corp., supra.

Should the emergency which this section is designed to meet eventuate, the corporation should, and should be able to, produce the surplus necessary to repurchase the shares, if the corporation is worth saving. See also note 19 infra.

such shares shall be entitled to any vote, nor shall any dividend be paid or allowed upon any of such shares, after failure to comply with such request.

Section 6. Redemption on Death.[19]—Upon the death of any shareholder, the Corporation shall purchase, and the estate of the decedent shall sell, all of the decedent's shares in the Corporation, and the Corporation shall take such action as may be necessary to permit it to make such purchase. Title to all of said shares shall be deemed to vest in the Corporation immediately upon the death of any such shareholder. The purchase price of such stock shall be computed in accordance with the provisions of the by-laws of this Corporation.

Section 7. Dissenting Shareholders.[20]—In the event that any share-

19. It is, of course, essential to make any restrictions on share transfers expressly binding on the estate of a deceased holder in order to keep the corporation close. See Globe Slicing Mach. Co. v. Hasner, 223 F. Supp. 589 (S.D.N.Y. 1963). In such a corporation there is usually no ready market for the shares of a participant. If the estate of a deceased is bound by a first option to sell to the corporation and the other shareholders but the latter are given the option to refuse to buy, as in many agreements, e.g., that in Lawson v. Household Fin. Corp., supra note 18, it is, then, ordinarily to the advantage of the other shareholders (for themselves and their corporation) to reject the offer, and blackmail the estate into selling at a lower price than the real value of the stock. Accordingly, to insure fairness, this provision requires the corporation to repurchase the shares of a deceased shareholder at the inter vivos value fixed in the by-laws. Since upon incorporation no participant will know which will die first, all should be willing to agree to insert the section, which prevents the survivors from later taking advantage of the widow and children of the participant unfortunate enough to die first.

Such a provision should be enforceable as an "agreement" under N.Y. Bus. Corp. Law § 514, as long as the corporation has a surplus when it is called upon to repurchase. Life insurance, owned by the corporation and payable to it as beneficiary, should be used to help guarantee the availability of such a surplus. (The cash proceeds of the policy will increase the assets, and result in a corresponding increase in the "Shareholder's Equity" on the right hand side of the balance sheet.) Should the surplus still not be sufficient, the corporation is required (under the clause requiring it to take such action as may be necessary) to reduce the stated capital to the extent necessary to create the sufficient surplus. See Prentice-Hall, Corporation Forms, ¶ 106, at 143 (1965). It is to be observed that even such an artificially created surplus is sufficient, since the Business Corporation Law only requires a "surplus" not an "earned surplus" for share repurchases. N.Y. Bus. Corp. Law §§ 513(a), 102(a)(13). Compare N.Y. Bus. Corp. Law § 102(a)(6), with N.Y. Bus. Corp. Law § 102(a)(2).

It should be noted that the provisions of this section and Section 4, where the by-laws fix a fair arm's length price, should meet the requirements of Treas. Reg. § 20.2031-2(h) (1958), so that if the deceased shareholder is in the federal estate tax bracket the valuation should control for such tax purposes. See Fed. Est. & Gift Tax Rep. ¶ 1202.03.

20. The purpose of this provision is to ensure that no shareholder can use a dissent and appraisal as a way of escape from the share restrictions, or a blackmail device against his fellow shareholders, by threatening to veto corporate action requiring shareholder approval unless he is bought out at a higher price than the agreed value of his shares. See Sands

holder becomes entitled to payment of the fair value of his shares under § 623 of the Business Corporation Law, or any amendment thereto, or related or similar statute, the fair value of his shares for all purposes thereunder shall be conclusively presumed to be the aforesaid price fixed by the by-laws of this Corporation, and the shareholder shall be bound to accept any offer of the Corporation to pay said amount in exchange for his shares.

Section 8. Transfers Void.[21]—No purported sale, assignment, mortgage, hypothecation, transfer, pledge, creation of a security interest in or lien on, encumbrance of, gift of, trust (voting or other) of, or other disposition of any of the shares of this Corporation by any shareholder in violation of the provisions of this Certificate of Incorporation or the by-laws shall be valid, and the Corporation shall not transfer any of said shares on the books of the Corporation, nor shall any of said shares be entitled to vote, nor shall any dividends be paid thereon during the period of any such violation. Such disqualifications shall be in addition to and not in lieu of any other remedies legal or equitable to enforce said provisions.

Section 9. Applicability of Other Portions of this Certificate.[22]—

Point Co. v. Rossmoore, 43 Misc. 2d 368, 251 N.Y.S.2d 197 (Sup. Ct. 1964), holding that a repurchase provision, not specifically dealing with the subject, did not prevent a shareholder from dissenting and receiving the appraised value of his shares rather than the price fixed for an ordinary redemption. There would seem to be no statutory objection to an advance agreed value for the shares, since N.Y. Bus. Corp. Law § 623(g) provides for an agreement between the dissenting shareholder and the corporation (by acceptance of the corporation's offered price) as to value. Furthermore, there should be no objection to an agreed "fair value" fixed in advance for purposes of N.Y. Bus. Corp. Law § 623(h)(4) which provides for the court to fix the "fair value" of the shares, where the corporation's offer is not accepted.

21. The detailing of varied corporate remedies is, of course, designed to make the restriction provisions as airtight as possible. There is no point in enumerating the sometimes conflicting New York decisions on the remedies available. The object of the provision is to guarantee that if one device fails another will be successful in preventing any transfers of whatever nature which violate the basic agreement. See 2 O'Neal, Close Corporations § 7.17 (1958).

Although provisions prescribing the mode of payment could be added, see, e.g., Lawson v. Household Fin. Corp., 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930), it is simpler to leave these matters for the by-laws.

See generally as to restrictions on transfer of shares, Annot., 61 A.L.R.2d 1318 (1958); Annot., 65 A.L.R. 1159 (1930).

22. The purpose of this provision is to guarantee that any additional limitations imposed by the by-laws will also be upheld. It should be observed in this connection that unlike many jurisdictions, New York upholds reasonable share restrictions even though only contained in the by-laws and not the certificate, at least as to persons with notice. See Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957), and the provision for adequate notice in Article 11. It is also designed to pave the way for such

Nothing contained in this Article shall be construed to limit or render ineffective any other provisions of this Certificate of Incorporation or the by-laws further restricting or conditioning the transfer of shares of this Corporation, or providing penalties or disqualifications for violations of said restrictions or conditions.[23]

* ARTICLE 5

The Secretary of State of New York is hereby designated as agent of the Corporation upon whom process against it may be served. The post office address to which the Secretary of State shall mail a copy of any process against the corporation served upon him is:[24]

ARTICLE 6

Section 1. Number of Directors.[25]—The number of directors which

provisions as those in Article 10 designed to guarantee that a Subchapter S election will not be terminated by share transfers.

23. See also note 26 infra.

24. The post office address may be within or without the state. A post office box rather than street address is sufficient. See N.Y. Bus. Corp. Law § 104(b).

The Secretary of State must be designated as a process agent. N.Y. Bus. Corp. Law § 304. A registered agent may be appointed as an additional agent for service of process. If one is desired the following provision should be added as Section 2 of this Article:

..... (Name of individual resident of and with business address in state, or domestic or foreign corporation licensed to do business in state; see N.Y. Bus. Corp. Law § 305(a)), whose address within this state is: .... (Must include street and number or other particular description) is hereby designated as registered agent of this corporation, and is to be the agent of the Corporation, in addition to the Secretary of State, upon whom process against it may be served.

The lawyer for the corporation may, of course, be designated as registered agent, or one of the service companies may be used. Although the designation of a registered agent may make service of process easier for a potential plaintiff against the corporation, it should also be noted that the corporation will be promptly notified of any suit against it if a reliable agent is designated, and the plaintiff chooses to avail himself of this mode of service.

25. The number of directors may be fixed in the certificate, if desired, where there are to be three or more. Where there are to be only two shareholders only two directors are necessary, although more may be used, e.g., to give additional board power to the shareholder contributing a greater investment. N.Y. Bus. Corp. Law § 702(a). Similarly, a one man corporation need only have one director. However, should the number of shareholders of a one or two man corporation increase, the number of directors would also have to increase, if set at less than the number of shareholders, N.Y. Bus. Corp. Law § 702(a). Manifestly, if the number of directors can be increased by a majority of the shareholders, as it can if the certificate is silent (the number is fixed in the by-laws under N.Y. Bus. Corp. Law § 702(a), and the by-laws can be amended by a majority of the voting shareholders at a shareholder's meeting at which a quorum is present, under N.Y. Bus. Corp. Law §§ 601(a), 608(a)—a by-law may even be passed by a similar shareholder vote to allow the directors themselves to increase their number), this poses a danger to the minority. If the number of directors is fixed in the by-laws and these can only be amended by unanimous

this corporation shall have shall be fixed in the by-laws (but shall in no case exceed the number of shareholders). There shall be no increase or decrease in the number of directors except as approved by the shareholders as hereinafter provided in Article 8.

Section 2. Requirement that Directors be Shareholders.[26]—No director of this Corporation shall qualify as such unless he is a shareholder. Whenever any director of this Corporation shall cease to be a shareholder his office as director shall become vacant.

Section 3. Vacancies.[27]—All vacancies on the board of directors how-

shareholder action as provided in Article 8, Section 2(I) the danger is removed. If the participation of each shareholder is to be equal and his representation on the board to correspond to that participation, the parenthetical clause may be added to make the arrangement airtight, and also to handle the situation when the number of shareholders is less than three, without the necessity for amendment of the by-laws to accommodate any decreases or increases in their number.

26. This form and those set forth below in this note are based on a form contained in 2 O'Neal, Close Corporations § 10.24 (1958). It is designed as a further safeguard against packing the board by the majority in violation of the original control arrangement. Alternative provisions requiring a certain percentage of stock ownership can be utilized where it is possible that some shares will be given to the families of the participants or employees, but it is desired to prevent them from having a say in the ordinary management of the corporation. Unless modified such a gift will require a waiver of the Article 4 provisions by all the shareholders under Article 8. The following is a possible form:

No director of this Corporation shall qualify as such unless he is the holder of at least ..... percent of the outstanding Common stock of this Corporation. Whenever any director of this Corporation shall cease to hold that percentage of the Corporation's outstanding Common stock, his office as director shall become vacant.

Where classes of shares are used, the form could read:

No director of this Corporation shall qualify as such unless he is the holder of at least ..... percent of the Class A, or at least ..... percent of the Class B, or at least ..... percent of the Class C Common stock of this Corporation then outstanding. Whenever any director of this Corporation shall cease to hold the requisite percentage of shares as aforesaid his office as director shall become vacant.

Such percentage provisions are also an additional safeguard, if the appropriate percentage is chosen, should any shares be transferred to outsiders despite Article 4, to prevent the upset of the prearranged control arrangement.

27. This provision guards against the dangers posed by N.Y. Bus. Corp. Law § 705(a). See Gearing v. Kelly, 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962). In lieu of this provision and that in Section 4 of this Article, the following from 2 O'Neal, Close Corporations § 10.09 (1958) may be used where the shares are classified and unanimity is not necessary:

Section 3. Election of Directors. Class A Directors shall be elected by the affirmative vote of holders of at least a majority of the shares of Class A Common Stock at the time outstanding. The holders of Class B Common Stock may not vote in the election of Class A Directors. The Directors of Class B Common Stock shall be elected by the affirmative vote of holders of at least a majority of the shares of Class B Common Stock at that time outstanding. The holders of Class A Common Stock may not vote in the election of Class B Directors.

Section 4. Removal of Directors and Filling Vacancies. Holders of Class A Common Stock shall have the right by the affirmative vote of holders of at least a majority of the shares of that class of stock at the time outstanding to remove any or all of the Class A

ever created shall be filled only by the shareholders, and only as hereinafter provided in Article 8.

Section 4. Election and Removal.[28]—No director shall be elected or removed for any reason whatsoever except by the shareholders, and only as hereinafter provided in Article 8.

Section 5. Compensation.[29]—The board of directors shall have no power to fix the compensation of any director for serving in any capacity. Such compensation shall be fixed only by the shareholders, and only as hereinafter provided in Article 8.

Section 6. No Power to Mortgage or Pledge.[30]—The board of directors shall have no power to sell, lease, exchange, mortgage, pledge, or otherwise dispose of, nor to encumber or create any security interest in or lien on, any of the property, real or personal, of the corporation without the respective approval of the directors or shareholders as hereinafter provided in this Article and Article 8.

Section 7. Engaging in Other Business.[31]—No director of this Cor-

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Directors, with or without cause, and shall have the right by that vote to fill any vacancy among the Class A Directors, whether arising from removal of a director or from other cause. Holders of Class B Common Stock shall have the right by the affirmative vote of holders of at least a majority of the shares of that class of stock at the time outstanding to remove any or all of the Class B Directors, with or without cause, and shall have power by that vote to fill any vacancy among the Class B Directors, whether arising from removal of a director or from other cause. (Italics omitted.)

If these provisions are used, Clause A of Article 8, Section 2 should be omitted, and the following clauses relettered.

28. This provision will prevent upsetting the control arrangement by removal of a director by the shareholders "for cause," except with his consent, see Article 8, Section 2(A), and also will prevent adoption of a by-law allowing removal "for cause" by the directors, or without cause by the shareholders. See N.Y. Bus. Corp. Law § 706(a), (b). See also note 27 supra.

29. This provision prevents unfair treatment of shareholders who may not be on the board, e.g., the estate of a deceased shareholder should the representative and the corporation waive their rights under Article 4, Section 6, through diversion of corporate profits into "salaries" for board members. See N.Y. Bus. Corp. Law § 713(c).

30. If unanimity is required under Article 8, Section 2(E) and Article 6, Section 9(G), the power to mortgage, pledge, etc., will not prove a danger. Otherwise, the board has power to mortgage all corporate assets without shareholder consent, N.Y. Bus. Corp. Law § 911, a manifest danger to minority directors and à fortiori to participants not represented on the board.

31. This provision was suggested by Miss. Bus. Corp. Act § 5309-71, and is designed to prevent a decision such as that in Lincoln Stores, Inc. v. Grant, 309 Mass. 417, 34 N.E.2d 704 (1941), which gave insufficient protection to their corporation from competition by its own directors and officers.

The words 'nor engage in any other business' might be added after the word "partnership" if not too restrictive of the activities of the participants. Such limitations on outside business should be permissible under N.Y. Bus. Corp. Law § 701, as to directors, and N.Y. Bus. Corp. Law § 715(g), as to officers.

poration shall become a director, officer, or employee of any other corporation, or association, nor a partner in any partnership, without the prior express approval of the shareholders as hereinafter provided in Article 8. The office of any director violating this provision shall immediately become vacant, and all shares of stock in this Corporation held by him shall immediately be offered for repurchase by the Corporation at the lesser of the amount fixed in the by-laws pursuant to Section 4 of Article 4 of this Certificate or (par) ($....).

Section 8. Quorum of Directors.[32]—The presence of all directors of this Corporation shall be necessary to constitute a quorum for the transaction of any business, except as otherwise provided in Section 11 of this Article.

Section 9. High Vote of Directors.[33]—The affirmative vote of all of the directors shall be required for the transaction of the following items of business:

(A) The hiring, discharge or indemnification of any employees (other than as officers or directors) of the Corporation, and the fixing of the compensation (of whatever form, direct or indirect, and whether paid to said employee or to a third party) and duties of all such employees, whether by contract or otherwise.[34]

(B) The discharge or suspension of any officer, except as otherwise required by Section 4 of Article 7.[35]

32. Permitted by N.Y. Bus. Corp. Law § 709(a)(1) and required to be in the certificate for effectiveness. Of course, a number less than all can be substituted, if desired. One object of such a high quorum provision is to allow a director to prevent being outvoted through the simple expedient of staying away from a meeting at which a unanimous vote is not required. As a result of the decision in Gearing v. Kelly, 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962), this device may no longer prove successful, since the case held a director who stayed away from the meeting could not question its validity.

33. Authorized by N.Y. Bus. Corp. Law § 709(a)(2), if in the certificate. Of course, less than all of the directors can be required. Unless the certificate fixes the number of directors (see Article 6, Section (1)), however, the number required for board action should be fixed as a fraction or percentage, here.

34. Unless deprived of the power by virtue of a N.Y. Bus. Corp. Law § 620(b) provision, the board has the power under its general management function to hire and fire corporate employees. See N.Y. Bus. Corp. Law § 701; Staklinski v. Pyramid Elec. Co., 6 App. Div. 2d 565, 180 N.Y.S.2d 20 (1st Dep't 1958), aff'd, 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959). Indemnification of employees (not officers and directors) is not regulated by statute. McKinney's Business Corporation Law § 721 & Comment. Employment contracts may be a way of guaranteeing financial security to the participants whether or not they are removed from their jobs as officers. Such agreements may also be used as a device to filter off corporate profits to the majority or their relations. See O'Neal & Derwin § 3.06. Whence the need for unanimous approval, to protect minority interests. See also note 63 infra.

35. Although discharge of an officer should be within the exclusive province of the

(C) The issuance of, and consideration for, any shares of stock of the Corporation, including Treasury shares.[36]

(D) The issuance of any rights or options to purchase, and the issuance of any securities convertible into, shares of stock of the Corporation, whether under a plan or otherwise, and to whomsoever issued.[37]

(E) Any change in the stated capital of the Corporation which by law the board of directors is authorized to make.[38]

(F) The declaration of any dividend, including any deficiency dividend, or the making of any distribution to the shareholders of this Corporation, whether in cash, property, stock, bonds or other securities of this or any other Corporation.[39]

(G) Any sale, gift, assignment, or other transfer of, lease, exchange,

shareholders by virtue of Article 7, Section 1, and Article 8, Section 2(B), a repetition of the provision here will prevent removal of any officer appointed by the board under a waiver of these provisions, and the requirement of unanimity for suspension plugs the loophole of N.Y. Bus. Corp. Law § 716(a) which allows an officer even though appointed by the shareholders to be suspended by the board.

36. Plugs a loophole under N.Y. Bus. Corp. Law § 504(c), created by the power of the board to issue up to the authorized limit (set in Article 4, Section 1) of par stock at par, although this may dilute the interest of shareholders not purchasing. See Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946); Dunlay v. Avenue M Garage & Repair Co., 253 N.Y. 274, 170 N.E. 917 (1930); O'Neal & Derwin § 4.14. Despite the change in verbiage in the course of passage ("on such terms and conditions as are" was substituted for "for such consideration as is"), N.Y. Bus. Corp. Law § 504(c), which provides: "Treasury shares may be disposed of by a corporation on such terms and conditions as are fixed from time to time by the board," apparently authorizes reissue of treasury stock at even less than par, an even more obvious dilution device. See Otter v. Brevoort Petroleum Co., 50 Barb. 247 (N.Y. Sup. Ct., 1867). Unless shares reacquired from a deceased or retired participant are to be automatically cancelled, which can be provided for in the certificate under Article 4, if desired, N.Y. Bus. Corp. Law § 515(a), the possibility of reissue poses such a danger to a minority that a requirement for unanimity seems clearly indicated.

37. This provision is designed to prevent the board from issuing options, etc., N.Y. Bus. Corp. Law § 505(a) or convertible bonds, N.Y. Bus. Corp. Law § 519, without minority approval, to prevent utilization of this subtle dilution device. See also Article 8, Section 2(K) and note 74 infra.

38. Plugs loophole created by N.Y. Bus. Corp. Law § 516(a), under which the board can reduce stated capital in certain instances without shareholder approval. Such a reduction can create a surplus to be used as a squeeze-out device by payment of excessive dividends. See O'Neal & Derwin § 4.12.

39. Dividends in cash may be a squeeze-out device. See O'Neal & Derwin § 5.14, at 135. The other limitations are complementary to those forbidding issuance of additional securities. See N.Y. Bus. Corp. Law § 510(a). Since the failure to declare a dividend can also be a squeeze-out device, O'Neal & Derwin § 3.04, it may be desirable to include a provision requiring the declaration of dividends where the corporation's financial condition makes such dividends possible. See note 93 infra. If such a mandatory dividend provision is used, the words "other than as required by this Certificate of Incorporation" should, of course, be added, at the end of this clause.

mortgage, or pledge of, or creation of a security interest in or lien on, any of the assets of the Corporation (whether before or after dissolution), where the then market value of the asset sold, given, assigned, transferred, leased, exchanged, mortgaged, pledged, or in which a security interest or lien is created exceeds $.....[40]

(H) The authorization of any merger or consolidation of this Corporation with any other Corporation, domestic or foreign, any plan for any such merger or consolidation, or any contract which in effect constitutes a merger or consolidation.[41]

(I) Any loan to, or agreement to guarantee, answer for, or indemnify against, any act, debt, obligation, default or miscarriage of any person, partnership, association or corporation, including this Corporation, whether or not in furtherance of the corporate purposes of this Corporation.[42]

(J) Any resolution authorizing the making, execution, delivery, or endorsement of any commercial paper the face amount of which exceeds $....., and any guaranty of any commercial paper regardless of the face amount thereof.[43]

(K) Any resolution authorizing any contract or obligation which creates a liability, certain or contingent, in excess of $.....[44]

(L) The commencement of any action or proceeding (including the submission of any claim to arbitration), against any person, corporation, association or partnership, including any officer, director, employee or shareholder of this Corporation.[45]

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40. The figure inserted here should be the same or less than that under Article 8, Section 2(E). The figure set should be considered in conjunction with the figures used for other contracts (Article 6, Section 9(J), (K)), and the provisions of Article 7, Section 3.

41. Plugs loophole through the "short merger" statute, N.Y. Bus. Corp. Law §§ 905, 907(c). See O'Neal & Derwin § 4.05. Reference to a contract which in effect constitutes a merger or consolidation, here and in Article 8, Section 2(D), may not be necessary in view of the restrictions on "sales," see N.Y. Bus. Corp. Law § 909; Article 6, Section 9(G); Article 8, Section 2(E). The purpose, of course, is to prevent any "de facto" mergers. See Cheff v. Mathes, 199 A.2d 548 (Del. Sup. Ct. 1964); Hariton v. Arco Electronics, Inc., 182 A.2d 22 (Del. Ch. 1962), aff'd, 188 A.2d 123 (Del. Sup. Ct. 1963). Compare Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).

42. This provision, coupled with Article 8, Section 2(F) is designed to protect the minority from possible losses due to guarantees of obligations of third parties, e.g., the majority shareholder or a corporation in which he has an interest, plugging a possible loophole through which the guarantee might be upheld as somehow in furtherance of the corporation's purposes. See O'Neal & Derwin § 5.05, at 108. As to loans, see also note 78 infra.

43. The amount here should be the same as that in Article 7, Section 3.

44. See note 43 supra.

45. This provision, coupled with the denial of officer powers in Article 7, Section 3, will,

(M) Any action, proceeding or the filing of any petition for the bankruptcy, reorganization, or receivership of the Corporation; or, except as otherwise expressly required by law, the presentation of any petition for judicial dissolution of the Corporation.[46]

(N) The making of any election or the giving of any consent under the United States Internal Revenue Code, or the tax statutes of any state, and the termination, revocation or cancellation of any such election or consent.[47]

Section 10. Vote on Other Matters.[48]—The number of votes of directors that shall be necessary for the transaction of any business (including any request under Article 4, Section 5, or Article 10, Section 3), other than that specified in Section 9 of this Article, shall be (.....) (that number which most closely approximates ..... percent of the number of directors provided in the by-laws then in force as the number of directors which this corporation shall have).[49]

Section 11. Action During Vacancy.[50]—The board of directors shall

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for the corporation, "overrule" Lasker v. Moreida, 38 Misc. 2d 348, 238 N.Y.S.2d 16 (Sup. Ct.), aff'd mem., 19 App. Div. 2d 646, 241 N.Y.S.2d 897 (2d Dep't 1963), in which the director-president was held to have inherent power to commence suit in the corporation's name against his co-participants (in the absence of a by-law provision forbidding him from doing so), and because of a requirement for director unanimity for all action, could not be forced by the other directors to discontinue the action. See also note 93 infra.

46. See note 58 infra. See also O'Neal & Derwin §§ 4.09, .13, as to dangers guarded against.

47. See note 75 infra.

48. Again, as with shareholder action, see note 77 infra, all director action can be required to be unanimous. This increases the probability of deadlock, and, accordingly, a lesser percentage should probably be required for matters not so vital as those set forth in Section 9. Otherwise, a disproportionate power is given to a minority represented on the board.

49. Unless the certificate fixes the number of directors, see note 25 supra, some alternate in terms of a percentage will have to be used to avoid necessity for amendment of the certificate should the by-laws be amended to change the number of directors.

50. This form is based on 2 O'Neal, Close Corporations § 10.24 (1958), modified to allow the corporation to do what is necessary to repurchase his shares when the vacancy is created by death of a participant, and to allow normal corporate operations to continue during this period.

This Article might also contain a provision fixing the place for meetings of the board, although as indicated above in the introductory text, p. 547 supra, it may be desirable to leave this matter for the by-laws. A certificate provision might take the following form:

Section 12. Place of Meetings. All meetings, regular and special, of the directors of this Corporation shall be held only within the State of New York, and only (within the County of .....) (within the City of .....) (at the Corporation's office) (at [exact address]).

One of the parenthetical provisions should be chosen.

not pass any resolution or take any action whatsoever, other than such as shall be necessary to comply with the provisions of this Certificate of Incorporation relating to the repurchase of a deceased shareholder's stock and the Corporate by-laws and any contract entered into consistent therewith relating to such repurchase, while any vacancy for whatever cause exists on the board, *provided* only that the ordinary salaries of employees who are not shareholders or directors of the Corporation may be paid, and contracts approved prior to such vacancy in conformity with this Certificate of Incorporation and the by-laws of this Corporation may be performed in accordance with the terms thereof.

ARTICLE 7

Section 1. Election of Officers.[51]—This Corporation shall have such officers as are provided for in the by-laws. All such officers, however, shall be elected and removed only by the shareholders and only in accordance with the provisions of Article 8.

Section 2. Rights on Suspension.[52]—No suspension by the board of directors of any officer, whether with or without cause, shall operate to deprive him of any salary, wages or other compensation, to which he would otherwise be entitled under the by-laws or any contract of employment with the Corporation.

Section 3. Powers.[53]—No officer of this Corporation shall possess any

Such a provision is complementary to that in Section 8 of this Article to ensure that no meetings can be held without all participants. See note 32 supra.

It should be noted that, unlike the ABA-ALI Model Bus. Corp. Act, Optional § 39A (1953), New York gives no authorization for separate consent of all directors as a substitute for a meeting. Compare N.Y. Bus. Corp. Law § 708.

51. Officer status at an agreed compensation is one way of securing a desired return from the investment in time and money in the corporation. A one man corporation will only want the minimum number of officers, i.e., two, N.Y. Bus. Corp. Law § 715(c). Other corporations may want more, e.g., officers from each faction. Since, if the suggested Certificate provision is adopted, the by-laws can only be amended by unanimous shareholder consent, Article 8, Section 2(I), any danger of a "freeze-out" by creation of more offices, at salaries which will divert what would otherwise be corporate profits to those chosen by the majority, is obviated, no danger is posed by leaving the matter of the number of officers to the by-laws.

Whether proportional or equal control is desired, it can be more easily reflected on the shareholder level than on the directorial one, hence the provision, permitted by N.Y. Bus. Corp. Law § 715(b), that all officers shall be elected by the shareholders.

52. Even though officers are elected by the shareholders they may be suspended by the board. N.Y. Bus. Corp. Law § 716(a). This provision helps to discourage such suspension. See also Article 8, Section 2(B) requiring unanimity for removal of an officer, the only way of protecting an officer's contract rights where the removal is for "cause."

53. It is, of course, possible to give very broad powers to the participants in their capacity as "officers." Ordinarily, the grant of such powers is dangerous. See Lasker v.

power whatsoever, unless expressly authorized to act in the particular matter as hereinafter provided in Article 8, except that (any officer) (the president, etc.) shall have power, without prior approval of the board of directors, to make, execute, deliver or endorse (but not make any guaranty of) any commercial paper the face amount of which does not exceed $....., and shall have the further power to enter into contracts of purchase or sale in behalf of the Corporation where the liability incurred under any such purchase contract does not exceed the sum of $....., and the value of the property sold does not exceed $.....

Section 4. Engaging in Other Business.[54]—No officer of this Corporation shall become a director, officer or employee of any other corporation, or association, nor a partner in any partnership, without the express approval of the shareholders as hereinafter provided in Article 8. The office of any officer violating this provision shall immediately become vacant, and all shares of stock in this Corporation held by him shall immediately be offered for repurchase by the Corporation at the lesser of the amount fixed in the by-laws pursuant to Section 4 of Article 4 of this Certificate or (par) ($.....).

ARTICLE 8

Section 1. Quorum of Shareholders.[55]—The presence in person or by proxy of all of the holders of the Common stock of this Corporation shall be necessary in order to constitute a quorum for the transaction of any business at any meeting of the shareholders of this Corporation.

Section 2. High Vote Requirement.[56]—The affirmative vote or consent of all[57] of the shareholders of the Common stock of this Corpora-

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Moreida, 38 Misc. 2d 348, 238 N.Y.S.2d 16 (Sup. Ct. 1963), aff'd mem., 19 App. Div. 2d 646, 241 N.Y.S.2d 897 (2d Dep't 1963). Such a limitation as that proposed may bind third parties. See N. A. Berwin & Co. v. Hewitt Realty Co., 199 App. Div. 453, 191 N.Y.S. 817 (1st Dep't 1922), aff'd per curiam, 235 N.Y. 608, 139 N.E. 754 (1923). See generally, 19 C.J.S. Corporations §§ 993, 997 (1940). Exceptions for small contracts are, of course, desirable, E.g., even the mustard man in the incorporated hot-dog stand may want to be able to order a fresh supply of condiments.

54. See note 31 supra.

55. This provision is permitted by N.Y. Bus. Corp. Law § 616(a)(1), and must be in the certificate to be effective.

56. This provision too is authorized by N.Y. Bus. Corp. Law § 616 and must be in the certificate to be effective.

57. A percentage or fraction may be substituted instead. If one is used, it must, of course, be carefully chosen, to reflect the agreed upon control arrangement. For adequate protection of a minority interest probably the entire list of provisions in this section should, however, require unanimity.

tion, regardless of class, shall be necessary for the transaction of the following items of business:

(A) The election[58] or, except as provided in Section 7 of Article 6 of this Certificate, the removal (with[59] or without cause)[60] of any director, regardless of which class has elected him, and the filling of any vacancy on the board however created.[61]

(B) The appointment or, except as provided in Section 4 of Article 7 of this Certificate, the removal (with or without cause) of any officer.[62]

58. This provision will implement a shareholder's agreement to elect the participants and keep them in office. Where the agreement does not include all of the participants, as, of course, it need not, N.Y. Bus. Corp. Law § 620(a), the words "election or" should be deleted. Removal should still probably require unanimity (at least for removal without cause), unless dummies are to be used on the board to secure proportionality of representation. It should be noted that where more than a plurality of votes of a class is required to elect a director, one-third of the shareholders entitled to vote for voluntary dissolution (ordinarily the shares entitled to vote for directors and those entitled to vote for dissolution will be the same) cannot be prevented from filing a petition for judicial dissolution if a deadlock develops or "there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders." N.Y. Bus. Corp. Law § 1104(a)(3). See N.Y. Bus. Corp. Law § 1104(b). If the shares are classified as above suggested with each participant receiving at least a majority of a class, it would seem unnecessary to require more than a plurality, and thus possible to prevent presentation of any petition for judicial dissolution under this section and N.Y. Bus. Corp. Law § 1104(c) (petition where a failure to elect directors for two years), while still achieving the same guarantee of board representation. See N.Y. Bus. Corp. Law §§ 614(a), 617(b), 703(a). In order to do so, however, all requirements for more than a majority vote of the board (Article 6, Sections 9 and 10) must also be deleted. N.Y. Bus. Corp. Law § 1104(b). Since this will ordinarily be dangerous to the minority, it will be impossible to absolutely prohibit the filing of a petition for dissolution unless all power is withdrawn from the board by a N.Y. Bus. Corp. Law § 620(b) provision.

It is desirable for the participants themselves, in advance of any dispute which may later arise, to determine the circumstances under which they will want their corporate venture to terminate, rather than leave this decision to a court. Manifestly, the best contrived control arrangement is of no value if a participant can "opt-out" any time he wants by dissolving the corporation, or use the threat of dissolution for extorting concessions from his co-participants. Accordingly, provisions have been added in this Article (Section 2(G) and (H)), and Article 6 (Section 9(M)) to plug this loophole so far as possible. Since some fair escape device is necessary to avoid complete paralysis and consequent business failure, should a serious and continued rift eventuate, a separate Article has been added dealing with this subject (Article 9).

59. Plugs loophole in N.Y. Bus. Corp. Law § 706(a), allowing removal for cause by vote of shareholders, and prevents enactment of a by-law allowing directors to remove a fellow director. See also note 28 supra.

60. Plugs loophole in N.Y. Bus. Corp. Law § 706(b), allowing shareholders to enact a by-law providing for removal of directors without cause.

61. It should be noted that this clause, Section 2(A), should be omitted entirely if the alternate provisions for Article 6, Section 3 and 4 are utilized. See note 27 supra.

62. Article 7, Section 1 provides, as allowed by N.Y. Bus. Corp. Law § 715(b), for elec-

(C) The fixing of the compensation (of whatever form, direct or indirect, and whether paid to said director or officer or to a third party) and duties, and any changes therein, of any director or officer; and the granting of permission to any director or officer to become a director, officer or employee of any other corporation or a partner in any partnership.[63]

(D) Any merger or consolidation of the Corporation with any other corporation, domestic or foreign, and any contract which in effect constitutes a merger or consolidation.[64]

(E) Any sale, gift, assignment or other transfer of, lease, exchange, mortgage or pledge of, or creation of a security interest in or lien on, any of the assets of the Corporation (whether before or after dissolution),[65] where the then market value of the asset sold, given, assigned, transferred, leased, exchanged, mortgaged, pledged, or in which a security interest or lien is created exceeds $.....[66]

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tion of officers by the shareholders. This itself plugs a loophole in N.Y. Bus. Corp. Law § 716(a), which allows board-appointed officers to be removed with or without cause by the directors. A unanimity requirement will also prevent removal of a shareholder-officer even by the shareholders. Having the officers elected by the shareholders will prevent possible unenforceability of such a typical shareholder agreement provision as that in McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934), wherein the participants agreed to act (as directors) to keep certain persons as officers at stated salaries. See also, Israels, Corporate Practice 377-78 (1963).

63. Plugs a loophole, permitted by N.Y. Bus. Corp. Law § 713(c), for diversion of corporate profits to participants who are directors from those who are only shareholders, and not also directors. See also note 31 supra. The parenthetical matter is designed to insure that all forms of compensation, e.g., pensions, bonuses, widow's benefits, etc., will require the same shareholder approval (See N.Y. Bus. Corp. Law § 202(a)(13). As to death benefits, see Int. Rev. Code of 1954, § 101(b). Where the financial condition of the corporation justifies it, such special compensation plans should, of course, be considered and given advance authorization.

64. Plugs a loophole created by N.Y. Bus. Corp. Law §§ 901, 903(a)(2), 907(a), (b), whereby two-thirds of the outstanding voting shares may authorize a merger or consolidation. As to the dangers from a merger or consolidation, see O'Neal & Derwin §§ 4.05, .06, .07. See also Article 6, Section 9(H) plugging the loophole whereby the directors may merge or consolidate without shareholder approval under N.Y. Bus. Corp. Law §§ 905, 907(c).

65. See N.Y. Bus. Corp. Law §§ 1005(a)(3)(A), 1006(a)(2). The provisions are designed to insure that a minority will still be able to exercise its veto to prevent a liquidation sale at which the price will be unfair to it. As to dangers from such a liquidation sale, see O'Neal & Derwin §§ 4.09, .10, .11.

66. Plugs loopholes created under N.Y. Bus. Corp. Law §§ 909, 911, whereby the directors can mortgage or pledge any or all property, and can sell, lease or exchange any corporate property unless the latter disposition both amounts to "all or substantially all the assets of the corporation," and the sale, lease or exchange is "not made in the usual or regular course of the business actually conducted." There is no express authorization to limit the right of sale, lease or exchange except as provided in § 909 (requiring two-

(F) Any guaranty not in furtherance of the corporate purposes.[67]

(G) Non-judicial dissolution of the Corporation, except as otherwise specified in Article 9.[68]

(H) Except as otherwise expressly required by law, the presentation of any petition for judicial dissolution of the Corporation.[69]

(I) Any amendment of the by-laws (including, but without limitation thereto, any change in the number of directors,[70] or officers, and any change in the price fixed pursuant to Articles 4 and 9 of this Certificate for its shares of stock) of this Corporation.[71]

(J) Any amendment of or change in this certificate of incorporation[72]

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thirds of the shareholders entitled to vote thereon, where these two conditions are met). Such a limitation might, accordingly, be considered improperly restrictive of the powers of the board, a N.Y. Bus. Corp. Law § 620(b) provision. In order to avoid such an interpretation a corresponding (unanimity) provision is inserted in the Director portion of the certificate. See Article 6, Section 9(G). There would seem to be no objection to a restriction which requires shareholder approval of directorial action even without a special § 620(b) provision. See Ripley v. Storer, 1 Misc. 2d 281, 139 N.Y.S.2d 786 (Sup. Ct.), aff'd mem., 286 App. Div. 844, 142 N.Y.S.2d 269 (1st Dep't 1955), modified on other grounds, 309 N.Y. 506, 132 N.E.2d 87 (1956). Thus, the restriction here should be unobjectionable.

To avoid any possibility that this provision might be considered a § 620(b) provision, the clause could be divided into two parts as follows:

Any sale, lease, exchange or other disposition of all or substantially all of the assets of the Corporation, unless made in the usual course of the business actually conducted by the Corporation.

Any mortgage or pledge of, or the creation of any security interest in or lien on, any part of the Corporation's property or any interest therein, wherever situated, except as otherwise provided in Article 6, Section 9(G).

These practically copy the language of the respective statutes involved, N.Y. Bus. Corp. Law §§ 909, 911. Presumably, more than the "two-thirds of all outstanding shares" required by N.Y. Bus. Corp. Law § 909(a)(3), is permissible.

Manifestly, for protection against sales, etc., of less than "substantially all" of the corporate assets (and even for sales of all if in the regular course of business), where this modified provision is used, the requirement of board unanimity, Article 6, Section 9(G), must be relied upon to protect the minority.

67. Plugs a loophole created by N.Y. Bus. Corp. Law § 908 which allows two-thirds of the shareholders to give a guaranty even though not in furtherance of the corporation's purposes, e.g., of the personal obligation of a major participant.

68. Designed to plug a loophole created by N.Y. Bus. Corp. Law § 1001 which allows two-thirds of the outstanding shares entitled to vote thereon to dissolve the corporation. As to the dangers from such dissolution see O'Neal & Derwin § 4.09. See also note 58 supra. If no special provision for dissolution is to be included in the certificate, the phrase after the comma should be deleted, and a period substituted for the comma.

69. Designed to plug loopholes created by N.Y. Bus. Corp. Law § 1103, and to the extent possible, N.Y. Bus. Corp. Law § 1104. See also note 58 supra.

70. See Article 6, Section 1.

71. This provision is vital to prevent an alteration of the agreed upon control structure.

72. See note 71 supra.

It might be desirable here to expressly provide that no shareholder approval will be

including (excluding)[73] changes in the location of the Corporation's office, the post office address to which the secretary of state shall mail a copy of any process against the Corporation served upon him, and any appointment, revocation or change in the designation of a registered agent or his or its address.

(K) The issuance of any rights or options to purchase, and the issuance of any securities convertible into, shares of the Corporation, whether under a plan or otherwise, and to whomsoever issued.[74]

(L) The making of any election or the giving of any consent under the United States Internal Revenue Code, or the tax statutes of any state, and the termination, revocation or cancellation of any such election or consent.[75]

(M) Any amendment which adds to, strikes out, or changes in any way, any of the provisions of this Article, or any of the provisions of Article 6, or Article 9.[76]

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required for a reduction of stated capital necessary to meet the corporation's obligation to repurchase the shares of, at least, deceased shareholders, since such a capital reduction may be required to produce a surplus for such repurchase. The provision might take the following form:

provided that all the then shareholders shall be deemed to have unanimously consented to any pro rata reduction of the stated capital, including any reduction in the par value of shares with par value, of all shares of the common stock then outstanding, including the shares of the decedent, necessary to permit the Corporation to carry out its obligations under Article 4, Section 6 of this Certificate.

73. The changes which follow are probably not important enough to require unanimity as opposed to the board approval allowed under N.Y. Bus. Corp. Law § 803(b). In order to avoid ambiguity, however, the certificate should be specific as to whether or not such changes are to require the same shareholder approval as other more important matters. Clearly, either "including" or "excluding" should be used in accordance with this choice. It should be remembered that if excluded here, the changes will be made as authorized by the board under Article 6, Section 10, unless added to Section 9.

74. Plugs loopholes under N.Y. Bus. Corp. Law §§ 505, 519(b), which otherwise can be used to dilute a participant's financial and control interest.

75. This provision is designed to cover such tax elections as that under Subchapter S of the Internal Revenue Code. Although all shareholders must consent to an election, anyhow, see Treas. Reg. § 1.1372-2(a) (1959), the provision may have some utility in preventing a later revocation or termination. See, e.g., Treas. Reg. § 1.1372-4(b)(1)(iii), (2) (1959); Treas. Reg. § 1.1372-5(a) (1959). See also Treas. Reg. § 1.565-1 (1958) (consent dividends); Treas. Reg. §§ 1.1502-1, -12 (1955) (consolidated returns).

The reference to state tax statutes will cover any possible amendment to the New York statutes, such as that found in some states, see, e.g., Vt. Stats. Ann. § 32-6101, allowing an election on the state level similar to Subchapter S.

76. This provision is necessary to plug loopholes in N.Y. Bus. Corp. Law §§ 616(b), 709(b), under which two-thirds of the shareholders can amend or strike out a high vote requirement, see Hoffman, New Horizons for the Close Corporation in New York Under Its New Business Corporation Law, 28 Brooklyn L. Rev. 1, 5 (1961), and to be explicit as to the vote required to amend a special dissolution provision under N.Y. Bus. Corp.

Section 3. Vote on Other Matters.[77]—The proportion of affirmative votes or consents of the holders of shares necessary for the transaction of any business, other than that specified in Section 2 of this Article, shall be ..... percent of the outstanding shares of the Common stock of this Corporation.

Section 4. Loans to Directors.[78]—Notwithstanding any of the foregoing

Law § 1002(b). Of course, if no special provision for dissolution is included, the reference to Article 9 should be omitted.

Other provisions can, of course, be added. For example, if any of the shares of the corporation are to be no-par, a provision like that in Article 6, Section 9(C) should be added here, since under N.Y. Bus. Corp. Law § 504(d), the consideration for such shares can be fixed by the shareholders. It should be observed that N.Y. Bus. Corp. Law § 504(c), gives no such option in the case of par value shares. Retention by the shareholders of the power to fix the consideration of no-par shares, also can prevent reduction of the stated capital of such shares by the board. N.Y. Bus. Corp. Law § 516(a).

77. If unanimity, or the same high vote, is to be required for all shareholder action, Section 2 may be eliminated entirely, and only this section (renumbered, and omitting the reference to Section 2) utilized. The high vote need not, of course, give a veto. For example, in a corporation with five equal participants, it may be decided to require the concurrence of two to prevent a decision. Thus, a vote of 61% would be required for shareholder decisions. In order to minimize the danger of deadlock, where unanimity is required for the fundamental changes set out in Section 2, it may well be decided to require a percentage less than the equivalent of all, perhaps even a mere majority, to control in less significant areas.

Where the shares are classified the provision may be amended to read:

..... percent of the outstanding Class A stock, plus ..... percent of the outstanding Class B stock, plus ..... percent of the outstanding Class C stock of this Corporation.

As a further alternative, the provision might read:

..... percent of the total outstanding Common Stock, regardless of class, of this Corporation.

It should be observed that these two provisions may prove different. Thus, in a three-man corporation in which the financial contributions are equal, a 66% requirement for each of three classes will guarantee each a veto, a 66% over-all (total) requirement will not. In order to avoid any question of meeting the requirements of Subchapter S, see Treas. Reg. § 1.1371-1(g) (1959), the over-all percentage high enough to give a veto, if desired, is preferable. E.g., 67% over-all in the example will guarantee the veto, and clearly not disqualify the corporation.

If the shares are to be treated as all of the same class for all purposes other than election of directors, see note 10 supra, no special provision would seem necessary, even if the shares are classified, i.e., the provision in the Certificate should be sufficient.

A provision similar to that discussed in note 50 supra for directors' meetings might here be inserted, with the section number changed to "4," and the word "shareholders" substituted for "directors."

78. Loans to participants pose a special problem. N.Y. Bus. Corp. Law § 714 provides: A loan shall not be made by a corporation to any director unless it is authorized by vote of the shareholders. For this purpose, the shares of the director who would be the borrower shall not be shares entitled to vote. A loan made in violation of this section shall be a violation of the duty to the corporation of the directors approving it, but the obligation of the borrower with respect to the loan shall not be affected thereby.

provisions of this Article, and any other provision of this Certificate of Incorporation, the quorum shall consist of, and the affirmative vote or consent of the holders of all of the outstanding shares of the Common stock of this Corporation, excluding said director, shall be necessary to approve any loan to any director of this Corporation.

ARTICLE 9[70]

In the event that such written offer is not accepted in writing accompanied by full payment in cash or, at the election of the purchaser or

Accordingly, any loans made to participants who are directors will require approval by a majority of the shares voting at a shareholder meeting. Presumably, the shares of the director may not even be counted towards a quorum, since they are not "entitled to vote thereat." N.Y. Bus. Corp. Law § 608 (a). Accordingly, the statute itself may be sufficient protection against improvident loans. See also N.Y. Pen. Law § 664(4).

If it is not, as e.g., where the borrowing director has only a few shares, but has a relative or friend with a large number, some special provision should be made under a separate section unless the general percentage chosen for shareholder action under Section 2 is sufficient for adequate protection.

Requiring unanimous shareholder consent under Section 2 of this Article might conceivably be construed to prevent any such loan, since by the terms of N.Y. Bus. Corp. Law § 714 it could never properly be given. (Presumably, an exception to the quorum requirement of Section 1 would also have to be made to avoid ambiguity).

79. Any veto arrangement such as found in Articles 6 and 8 increases the danger of deadlock and consequent corporate paralysis. Some fair method of resolving the deadlock must be utilized. Since, as indicated above, dissolution can be a squeeze-out device, it is best to condition its availability in a manner which will ensure its use only as a final resort, and only under circumstances where all parties will be fairly treated. N.Y. Bus. Corp. Law § 1002 gives the participants a certain degree of flexibility in determining when their corporation will be dissolved. It provides:

(a) The certificate of incorporation may contain a provision that any shareholder, or the holders of any specified number or proportion of shares, or of any specified number or proportion of shares of any class or series thereof, may require the dissolution of the corporation at will or upon the occurrence of a specified event.

Presumably an arbitrator's decision might be the "specified event." See Kessler, Arbitration of Intra-Corporate Disputes Under New York Laws, 19 Arb. J. (n.s.) 1, 11-15, 85, 91-2, 96 (1964). It might also be failure of the corporation or other shareholders to accept a "double offer" (shareholder offers to buy out others or be bought out at a price he sets).

Where class election of directors is not used, dissolution might be made automatic, i.e., by allowing any shareholder to dissolve, where the statutory ground for a petition, failure to elect replacement directors for 2 years, N.Y. Bus. Corp. Law § 1104(c), has been met.

The form drafted provides for dissolution by any shareholder who is not brought out at a certain per cent of the price which he would receive on death (fixed in the by-laws pursuant to Article 4, Section 6). The percentage should, of course, be less than 100. Otherwise, a participant can use the threat of dissolution to extort unfair concessions, since, because the redemption price should be the full value, he will have nothing to lose by dissolution. (The best-outside-offer provision of Article 4, Section 4 could also be

purchasers as the case may be, a down payment of 30 per cent of the selling price,[80] and a note providing for payment in equal installments, without interest, over a period of ..... months, with acceleration of the entire obligation in the event of nonpayment of any installment when due, by the Corporation, or the other shareholders in proportion to their then shareholdings in the Corporation, or by one or more of said shareholders with the consent of all other shareholders excluding the shareholder making said offer, (through payment therefor in cash) within 30 days after the mailing of said offer, any shareholder (including the estate of a deceased shareholder) making a written offer, for acceptance first by the Corporation and then by the shareholders in the manner aforesaid on condition that the Corporation not accept, to sell all of his shares (of all classes) in the Corporation at a price which shall be not more than ..... per cent of the price fixed in the by-laws of this Corporation for a redemption pursuant to Article 4, Section 6 of this Certificate, may, at any time after the elapse of 30 days, but not more than 60 days thereafter, from the mailing, registered mail return receipt requested, of said offer to the Corporation and all of said shareholders (or after 30 days, and not more than 60 days, following the last of such mailings, if not all mailed on the same day, but, in no event, later than 100 days after the first such mailing), dissolve the Corporation by signing, verifying and delivering a certificate of dissolution to the department of state.

Except as otherwise expressly required by law, this Corporation shall not be dissolved except as provided in this Article and in Articles 6 and 8 of this Certificate.

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rendered nugatory, since a shareholder could force payment of the full amount fixed in the by-laws or dissolve, even though as will be typical where the corporation or other shareholders are unwilling or incapable of repurchasing at the price fixed, the best-outside-offer would be less.) A figure of, say, 75% of the fixed price (or its alternate, see note 15 supra) might be about right to discourage a participant from forcing a buy-out in the heat of a minor argument, while not being so low as to force a participant to "stay in" when the conflict with his co-participants has become deep-seated. It should be observed that a discontented participant has another "out" if the corporation is really prosperous: he can still sell to an outsider at a higher price unless the corporation or other shareholders buy him out under Article 4, Section 4. For an alternative "dissolution on failure to buy-out" provision, see 2 O'Neal, Close Corporations § 10.28 (1958).

80. This payment provision is designed to take advantage of Int. Rev. Code of 1954, § 453(b)(2)(A)(ii) so that the shareholder being bought out need only pay a tax on the payments as received.

It will also prevent the minority holder from using dissolution to squeeze out his co-participants by making his offer at a time when he knows they will not have enough cash to pay him off in full. Similar payment provisions can be added under Article 4, or, as suggested, left for the by-laws in connection with such sales, and redemptions.

ARTICLE 10[81]

Section 1. Effect of Tax Elections on Share Transfers.—Notwithstanding any of the foregoing provisions of this Certificate of Incorporation, in the event that this Corporation and the shareholders thereof make any tax election under the U.S. Internal Revenue Code, or the tax laws of any state, no shareholder shall make any disposition of any of his shares whether inter vivos or upon death, and whether by way of sale, gift, bequest, assignment, transfer, mortgage, hypothecation, encumbrance, pledge, creation of a security interest in or lien on, trust (voting or other), or any other means whatsoever, the effect of which is or may be to terminate any such election. Any such disposition shall be void, shall not be recorded on the books of the Corporation, and shall not entitle the holder to any rights of a shareholder whatsoever.

Section 2. Deceased Shareholders.[82]—In the event of the death of

81. The purpose of this Article is to protect a Subchapter S tax election from termination. Such a termination is a possible squeeze-out device. See O'Neal & Derwin § 5.12; O'Neal, Close Corporations § 2.04(f) (Supp. 1963). There are a number of ways in which an election may be terminated, automatically, and unfortunately unilaterally, by a participant. An obvious means is for a shareholder to give away a sufficient number of shares so that the total number of shareholders becomes eleven. See Int. Rev. Code of 1954, §§ 1371(a), 1372(e)(3); Treas. Reg. § 1.1372-4(b)(3) (1959).

Even though the number of shareholders remains less than eleven, termination may be achieved by a transfer to a nonresident alien or, if one is not handy, to any individual who does not consent to the election. Transfer to other than individuals, e.g., to corporations, partnerships or trusts, will have the same effect. Ibid. An exception is made for an estate, i.e., such a transfer to a non-individual will not terminate the election, unless the representative fails to consent within the time limit. Treas. Reg. § 1.1372-3(b) (1959). The biggest loopholes are, of course, gifts, and, for shareholders who want to retain full ownership rights, transfers to a voting trust, of which there is nothing, under present law, to prevent the "former owner" from being trustee. It should also be noted that the voting trust no longer has the disadvantage which formerly discouraged its use: it need not be open to the other shareholders. McKinney's Business Corporation Law § 621 & Comment (1963). Any transfer in trust, including one to a voting trust, will automatically terminate the election. See Treas. Reg. § 1.1371-1(c) (1959). Because the possibility of such transfers is often forgotten in drafting share transfer restrictions, this device especially may prove a very dangerous loophole.

The purpose of Section 1 is, of course, to prevent any such transfer. If Article 4, Section 4 is inserted as drafted, it should be noted that this section of Article 9 will only come into play if the participants fail to repurchase the outgoing shareholder's shares. Nonetheless, the danger is worth guarding against. The provisions of Section 1 should prevent a loss of the election even when the participants waive their rights under the other repurchase provisions of the Certificate. As will be discussed in the following note, the principal danger of termination, even under carefully drafted share repurchase provisions, will, however, come from the death of a participant.

82. Obviously, transfers by death cannot be prevented. Article 4, Section 6, provides for repurchase of the deceased's shares. It cannot, however, prevent Subchapter S termina-

any shareholder, unless termination of such election both can be and is prevented by action of the personal representative of the deceased, the price to be paid by the Corporation, under Article 4, Section 6, of this Certificate of Incorporation, for each of the shares of such deceased shareholder shall be the lesser of the amount fixed in the by-laws or (par) ($.....), and the estate and all beneficiaries thereunder shall be bound to transfer all of said shares to the Corporation at said price per share.

Section 3. Involuntary Transfers.[83]—Any person who becomes the holder or possessor of any shares, or share certificates, of this Corporation by virtue of any judicial process, attachment, bankruptcy, receivership, execution or judicial sale, shall take whatever action is necessary to prevent a termination of said election, and in the event that such termination nonetheless takes place, whether due to the fault of, or without the fault of, said holder or possessor, the price to be paid by the Corporation under Article 4, Section 5, of this Certificate of Incor-

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tion through failure of the executor or administrator to consent to the election. A new shareholder has 30 days to file a consent to the election. Treas. Reg. 1.1372-3(b) (1959) further provides: "If the new shareholder is an estate, the 30-day period shall not begin until the executor or administrator has qualified under local law to perform his duties, but in no event shall such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder."

If the executor or administrator fails to act within the 30 days the election terminates. Treas. Reg. 1.1372-4(b)(1) (1959). Although the contractual obligation of the corporation to purchase and the estate to sell might well be properly interpreted to revest the stock in the corporation immediately on death, precluding the estate from ever becoming a shareholder, the Regulations are silent on the subject, and, hence, until an actual exchange of cash (or notes) for certificates takes place, the estate will probably be regarded as a "new shareholder," and hence entitled to terminate the election. A shareholder agreement among the parties should require each to execute a will and insert an appropriate direction in it ordering the executor to file a timely consent. Neither the enforceability of such an agreement nor such a provision in a will seems to have been the subject of any judicial opinion, yet. However, a provision voiding any transfer to an estate upon failure of the personal representative to execute the necessary consent would seem to smack too much of a forfeiture for courts to uphold it. Whence, the provision for a reduced payment to the estate upon failure to comply. Payment of only par, even though the value of the stock has appreciated considerably, should be an enforceable penalty, see Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957), and perhaps even a smaller set dollar amount will be, and should be a sufficient inducement to the personal representative to execute the necessary consent. The certificate provision should also provide him with sufficient justification should any of the beneficiaries later challenge his action for some reason.

83. This provision is designed to prevent the loss of an election through an involuntary transfer of the shares of a participant. Again, as with death, such transfers cannot be absolutely prevented, although the dangers are already diminished by the provisions forbidding pledge, etc. Article 10, Section 1; Article 4, Section 4.

poration, for each of such shares so held or possessed shall be the lesser of the amount fixed in the by-laws or (par) ($.....), and the said holder or possessor shall be bound to transfer all of said shares to the Corporation at said price per share, whenever requested by the Board of Directors so to do.

Section 4. Effect of Cancellation of Termination.[84]—The fact that the appropriate tax authorities revoke the termination, or allow a re-election, shall not affect the obligation of the Corporation to pay no more than the minimum amount provided for under Section 2 or Section 3 of this Article, nor validate any disposition or transfer prohibited by Section 1 of this Article.

ARTICLE 11[85]

No shares of this Corporation shall be deemed properly issued, and no shares shall be transferred upon the books of the Corporation, nor shall any holder thereof be entitled to any rights of a shareholder, unless the certificate, or certificates, evidencing said shares bear conspicuously[86] on the face or back thereof the following notice:

"Transfer of these shares is restricted by provisions contained in Articles 4, 6, 7, 9 and 10 of the Certificate of Incorporation and the by-laws of this Corporation,[87] which also fix the value of said shares.

84. The district director has the power, under certain circumstances, to extend the time for filing a consent, Treas. Reg. § 1.1372-3(c) (1959), and the Commissioner has power to allow a re-election even though the five-year period of disqualification ordinarily incident to a termination, Int. Rev. Code of 1954, § 1372(f), has not elapsed, Treas. Reg. § 1.1372-5 (1959). The purpose of this section of the Certificate is to make it clear that the burden of preserving the tax election will not be on the remaining participants, and that, accordingly, once a termination has taken place the person bringing it about will not be entitled to claim a higher value for the shares (although, of course, the other shareholders may unanimously grant it), merely because it has somehow been possible to save the election or reinstate it.

85. This article plugs a loophole which would otherwise allow the majority of directors to issue share certificates without the required notices, and thus render the control arrangement ineffective, perhaps absolutely, and at least as against persons without actual notice of the provisions. See Tomoser v. Kamphausen, 307 N.Y. 797, 121 N.E.2d 622 (1954); Boornazian v. Sarkisian, 110 N.Y.S.2d 350 (Sup. Ct. 1952).

86. See New York Uniform Commercial Code § 8-204; N.Y. Bus. Corp. Law §§ 616(c), 620(g), 709(c), 1002(c).

87. Required by New York Uniform Commercial Code § 8-204, which provides: "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." Reasonable by-law restrictions are valid, i.e., even though not set out in the certificate of incorporation, under Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957). "Issued subject to restrictions in Sections 28, 29 and 39 of the By-laws" was held therein to be sufficient notice to comply with old

Article 8 of the Certificate of Incorporation requires the presence in person or by proxy of a greater proportion of shareholders, and the affirmative vote of a greater proportion of shareholders for shareholder action than would otherwise be required by law.[88] Article 6 of the Certificate of Incorporation requires the presence of a greater number of directors and the affirmative vote of a greater number of directors for director action than would otherwise be required by law.[89] Articles 6 and 7 of the Certificate of Incorporation limits the powers of directors and officers.[90] Article 9 of the Certificate of Incorporation contains provisions allowing any shareholder under certain circumstances to dissolve the Corporation.[91] The Certificate of Incorporation and by-laws of this Corporation contain other provisions specially regulating the operation of this Corporation and the rights, duties and powers of its shareholders, directors, officers and employees, all of which provisions are binding on the shareholders, directors, officers, employees and third parties dealing with the Corporation, and all persons are cautioned to familiarize themselves with all such provisions.[92] The Corporation will furnish to any shareholder upon request and without charge, a full statement of the designation, relative rights, preferences and limitations of the shares of each class of shares which the Corporation is authorized to issue."[93]

Personal Property Law § 176 (Uniform Stock Transfer Act § 15), and should be under the Uniform Commercial Code, also.

88. Required by N.Y. Bus. Corp. Law § 616(c).

89. Required by N.Y. Bus. Corp. Law § 709(c).

90. Although not specifically required by statute, the provision should bolster enforceability and forestall any argument that any of the provisions of the certificate improperly restrict the power of directors and hence must be referred to under N.Y. Bus. Corp. Law § 620(g).

91. Required by N.Y. Bus. Corp. Law § 1002(c).

92. See note 90 supra.

93. Required where the corporation is authorized to issue shares of different classes. N.Y. Bus. Corp. Law § 508(b).

Other provisions can, of course, be added. In fact, any provision proper for the by-laws can be inserted. N.Y. Bus. Corp. Law § 402(b). This manifestly leaves considerable leeway. Arbitration provisions might well be added in a separate article here. If they are, Article 6, Section 9(L), should be modified accordingly.

Since the right to examine corporate records, except the shareholder list and minutes of shareholder meetings, are apparently still left to common law formulation, see N.Y. Bus. Corp. Law § 624(f), there would seem to be no objection to broadening the right if desired. O'Neal suggests such a broadening. 1 O'Neal, Close Corporations § 3.63 (1958); for form, see 2 O'Neal, Close Corporations § 10.28, at 284 (1958). Such provisions may, however, prove dangerous. See Slay v. Polonia Publishing Co., 249 Mich. 609, 229 N.W. 434 (1930).

Provisions compelling declaration of dividends when the corporation's financial condi-

Executed this ..... day of ....., 19.....

.....

*[Type name as signed][94]

Incorporator

*[Address, including street and number, municipality and state]

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tion justifies them might also be added. For a possible form, see 2 O'Neal, Close Corporations § 10.22 (1958). The following might also be used:

Annual dividends on the common stock will be declared by the Corporation as follows: the total dividend shall be $.... payable out of the accumulated earned surplus in excess of $..... If 50% of the annual net profits after taxes exceed the minimum $...., then the directors, by vote in accordance with Article 6 of this certificate, shall have discretion to declare a dividend up to 50% of the annual net profit. If the net profits are less than $...., nevertheless the minimum dividend shall be declared providing the $.... accumulated earned surplus is maintained. 'Earned surplus' shall have the meaning given to it by the Business Corporation Law, or any amendment thereto.

This form is modified from Galler v. Galler, — Ill. —, 203 N.E.2d 577 (1964), wherein it was upheld.

Where any provisions authorized by N.Y. Bus. Corp. Law § 620(b) are utilized (attempts have been intentionally made to avoid such provisions), the share certificates, and, accordingly, the provisions required by Article 11 should include the following:

The Certificate of Incorporation also contains provisions, as authorized by § 620(b) of the Business Corporation Law, restricting the discretion and powers of the board of directors of this Corporation in its management of corporate affairs.

Because many of the provisions of this certificate are novel, it might be well to add a "severability clause." The following might be used:

Article .....

If any provision of this Certificate or the application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of this Certificate which can be given effect without the invalid provision or application, and to this end the provisions of this Certificate are declared severable.

This provision is practically copied from the severability clause of the Business Corporation Law itself. N.Y. Bus. Corp. Law § 111. It should relieve the Secretary of State from any responsibility for filing a certificate which in some respect exceeds the powers granted by the statute to corporations, and accordingly may result in the filing of certificates which might otherwise be returned for including provisions in the penumbral zone between the clearly authorized and the clearly prohibited. The danger inherent in any severability clause, however, is that after the judicial excision of any invalid provision the remaining ones may possibly provide a useful squeeze-out device for a participant who wants to escape from his bargain.

94. N.Y. Bus. Corp. Law § 402(a) requires that the certificate "be signed by each incorporator, with his name and address stated beneath or opposite his signature . . . ." N.Y. Bus. Corp. Law § 104(b) defines address to "include the street and number, or other particular description instead of a street and number." Although it can be argued that, by virtue of the exception contained therein, § 104(d) does not require a statement of the capacity in which the signer signs, it is simpler to include the capacity ("incorporator") in which the person signs, than risk any questioning of the proper execution of the certificate.

*State of .....
County of ..... ss.:[95]

On the ..... day of ....., 19...., before me personally came [name of incorporator], to me known to be the person described in and who executed the foregoing instrument, and acknowledged that he executed the same.

.....
[Type name as signed]
Notary Public

95. The certificate must be acknowledged. N.Y. Bus. Corp. Law § 402(a).