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Agreements for Small Corporation Control

Stanley Morganstern*

A CLOSE CORPORATION, one owned by a few shareholders, has many unique problems which if not recognized and anticipated may well destroy it. No one plan can be made for all close corporations, as the circumstances, both present and future, must dictate particular provisions of each plan.

Shareholders' Agreement

The plan needed to cope with the myriad of problems which might threaten profitable existence of a small business corporation derives its effectiveness through drafting such plan into what is commonly called a shareholders' agreement. Legal enforceability is the element which makes the agreement effective. Although shareholders are limited by law to the extent that they may agree to act in concert, the shareholders' agreement is a tool by which the interests of the corporation and individual shareholders are best protected.[1]

The holders of shares of stock of a close corporation choose the corporate form so as to, at least in theory, limit their personal liability and assure continuation of business beyond the departure of one of the principals. They do not usually wish to be bound by statutory requirements which might prevent them from exercising the degree of control they desire over the affairs of the corporation. The overall objective of the shareholders' agreement, then, is to insure continued corporate existence and its advantages, while at the same time to provide the holders with some of the basic attributes of a partnership.

There are several inherent problems in every close corporation which dictate basic objectives of a shareholders' agreement. Success factors of a close corporation usually are particular skills of one or more of the major shareholders or an intangible asset such as a production process, a patent or even a customer list. These factors require that one objective be to limit the entrance of outsiders who might reveal these secrets, and to assure that insiders leaving the corporation will not use their knowledge to compete. Outsiders may often interrupt smooth operations of a business and the exit of an insider may result in disproportionate control. Holders of shares of stock of a close corporation should be extremely interested in not only acquiring the partnership attribute of *delectus personae,* the ability to choose who shall and who shall not

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1 Oleck, Modern Corporation Law 464 (1 vol. Student ed., 1960); and in detail in, 3 Oleck, Modern Corporation Law, c. 56-58 (1965 supp. ed.).

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be an owner, but also in assuring that one owner's proportionate control will not be diluted by the transfer of another's shares.

Since there is little trading in close corporate shares, valuation is difficult. At some time during corporate life, a shareholder may wish to liquidate his investment, or his widow may be forced to. An agreement controlling the dispersion of those shares is of little value if the price at which the shares are to be transferred is not stated or ascertainable without considerable negotiation. A swift and orderly transfer of shares at the happening of a named contingency is an important objective of the shareholders' agreement, but no more important than assuring the transferor of full value for his shares.

Majority shareholders in a close corporation are usually concerned with earning a large return on their investments either as salaries or dividends.[2] The presence of minority holders, who often are more interested in financially sound, continued existence of the corporation, dictates the need for an agreement which will satisfy both interests.[3] Dissatisfied minority holders can cause a great deal of expense and litigation. The existence of minority interests certainly will affect the agreement as to how directors will be elected, the level of salaries to be paid, and how and when dividends will be paid.

The most basic objectives of a shareholders' agreement concerns the right to control day to day operations and major policy decisions of the corporation. Within limits, shareholders may agree as to directors and officers, when and if these people will be removed from office, salaries to be paid, methods of resolving disputes, voting procedures of the board and types of action needing shareholder approval. Further, shareholders may agree that at the happening of a specified event they will vote their shares in a predetermined manner.

Beyond these basic problems, the objectives and ultimate provisions of a shareholders' agreement depend upon particular needs and wishes of shareholders. Circumstances existing at the time of incorporation and anticipated changes should mold the agreement. Ages and health of shareholders will determine the relative possibilities of death or disability causing a need for transferring ownership. The number of shareholders, their respective holdings and business skills are factors to consider when determining particular provisions of the agreement. Anticipated future growth and needs for more financing, be it equity or debt, will bear heavily on provisions establishing dividend and salary policies, as well as on those safeguarding the proportionate ownership. Tax consequences, both as to the corporation and individual shareholders, must also be considered before choosing a plan of action.

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[2] O'Neal, Minority Owners Can Avoid Squeeze-Outs, 41 Harv. Bus. Rev. 150 (1963).
[3] *Ibid.*

Once general objectives of the agreement have been established, it is important to consider some of the alternative paths which may be followed in accomplishing each of these objectives.

Control Through Voting

Control of the corporation, through voting power, is initially dispersed by issuance of securities. The type and number of securities received by each shareholder determines his ability to control corporate activities. A shareholders' agreement should specify with clarity the relative voting power to be possessed by each investor, and the issuance of securities will effectuate those provisions. Consideration of existing circumstances is imperative in determining how control should initially be divided. Further, it is important for the investor to understand the nature of the securities he holds, whether they be debt or equity.

Capitalization of a small business corporation usually consists only of common shares equally divided among the owners with profit distribution, voting rights and participation at liquidation being equal. To fully understand his rights and obligations, the shareholder must look beyond the terms of the stock certificate into the corporate charter and bylaws, the statutes of the state and applicable case law.[4]

Circumstances may dictate a departure from normal practice. A corporation beginning business may be in need of more capital than the principal shareholders can provide. At this juncture, shareholders must decide whether to raise required capital by means of issuing additional shares of stock or debt securities or a combination of each. The latter might be the first choice of the shareholders if they do not wish to relinquish any control over corporate activities. Realistically, debt securities are not always the answer. Investors supplying capital to a new business usually are interested in protecting their funds by having some control over the use of those funds. It may be necessary, in order to attract needed capital, to relinquish some control at least for the period over which the investors will have their capital returned.

Although debt financing is attractive from a tax viewpoint,[5] a large amount of debt may make the corporation too thinly capitalized. If this occurs, the Internal Revenue Service might be inclined to treat debt as equity and interest payments as dividends.[6]

If an investor insists on some control, but debt securities appear to be appropriate from a corporate viewpoint, a voting arrangement may be entered into whereby the investor is accorded his desired control, but is willing to take a note, debenture or other debt security. The voting

[4] Votaw, Modern Corporations 44 (1965).

[5] 101 Tax Management, Corporations-Pre-Organization Planning A-21 (1965).

[6] *Id.* at A-22; Shaker-Lee Theatre Co., 14 T.C.M. 452 (1958).

arrangement should extend no longer than a term commensurate with repayment of the debt, and may be limited in scope to issues concerning disbursement of borrowed funds. In this way, the creditor will be protected while long-range control of the corporation will not be affected.

An investor may be satisfied without managerial control if he has a superior claim over other shareholders as to earnings and assets at liquidation. A pure debt security will give him both of these protections, but a preferred stock will do the same. Other investors may be satisfied with a mere speculative return and desire common shares. Here, nonvoting shares would satisfy the investor without diluting proportionate voting control.[7]

Major shareholders may wish to attract several small investors, perhaps employees. If it is felt that nonvoting common shares are appropriate, initial capitalization may consist of a large series of nonvoting common and a small series of voting or *management stock*.[8] Alternatively, stock retained by management could be endowed with multiple votes per share, while stock dispersed to small investors would be entitled to only one vote per share.[9]

Before distribution of control, as provided by initial capitalization, is altered by provisions of a shareholders' agreement, legal aspects of voting rights generally should be understood.

The basic tests of the validity of any provision of a shareholders' agreement are 1) compatability of the agreement with public policy, 2) adherence of the agreement to state laws and the corporate charter, and 3) effects of the agreement on rights of creditors and other shareholders.[10]

The *statutory norms* within which the corporation must exist are guideposts to be followed when drafting an agreement.[11] Beyond basic statutory requirements of filing a corporate charter, keeping corporate books and records, filing a corporate tax return and acting within the powers granted by the state through the charter,[12] shareholders are also bound to respect legal limitations on voting arrangements.

Shareholders cannot conduct day-to-day operations.[13] Agreements which attempt to divest the board of directors of their power to exercise independent judgment in determining policies of the corporation are

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[7] 2 Lasser, Executive Course in Profitable Business Management 56, 57 (1952).

[8] Grange & Woodbury, Corporation Law-Operating Procedures for Officers and Directors 169 (2d ed. 1964).

[9] *Ibid.*

[10] Fletcher, 5 Cyclopedia Corporations, Stock and Stockholders § 2064 (1961 rev. ed.).

[11] Robinson, Agreements and the Statutory Norm, 43 Cornell L. Q. 68 (1957).

[12] Oleck, *op. cit. supra* n. 1.

[13] Robinson, *op. cit. supra* n. 11.

invalid.[14] The agreement may, however, control actions of the board to the extent of specifying who corporate officers are to be,[15] what salaries are to be paid,[16] what dividend policy shall prevail,[17] and what percentage of the total vote is needed to pass a board resolution.[18]

Broadly speaking, an agreement may further provide that shareholders shall vote their shares in a prescribed manner when unusual issues, needing a shareholder vote, arise.[19] These may include removal of directors, liquidation, merger or consolidation or submission of disagreements to arbitration.[20]

Majority owners cannot, by agreement, exclude minority owners from exercising their percentage of control.[21] All voting agreements must be entered into in good faith and must be consistent with the interest of creditors, shareholders and the corporation alike.[22] The clearest and most simple way of explaining the legal qualifications of a valid voting arrangement was established in *Clark v. Dodge*[23] which set forth the *No Damage Test.* A voting agreement is not illegal as being against public policy merely because it slightly impinges on statutory provisions. Damages, suffered or threatened, to the public and other shareholders determine the validity of the agreement.

The drafting of the agreement can insure its validity if notice is paid to the above factors at which the courts usually look in determining the legal efficacy of a voting arrangement.

The most important legal aspect is the *pyramid* of corporate structure which must not be altered by the agreement.[24] Within this *pyramid,* shareholders must elect directors, directors must establish corporate policy, and officers must execute those policies.[25]

Every state grants to the shareholders of corporations the power to elect a board of directors who will be responsible for management of corporate activities.[26] This power is the shareholders most important

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14 McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

15 Schmith v. Fornander, 26 Misc. 2d 239, 200 N.Y.S. 2d 505 (Sup. Ct. 1960); Kronenberg v. Sullivan County Steam Laundry Co., 91 N.Y.S. 2d 144 (Sup. Ct. 1949).

16 Robinson, *op. cit. supra* n. 11 at 76.

17 O'Neal, Close Corporations, § 5.02 (1958).

18 Katcher v. Ohsman, 26 N.J. Super. 28, 97 A. 2d 180 (1953).

19 Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale L.J. 1040, 1045 (1950).

20 *Ibid.*

21 Bostwick v. Chapman, 60 Conn. 553, 24 A. 32 (1890).

22 Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936).

23 *Ibid.*

24 Cary, How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm, 48 Nw. U. L. Rev. 427 (1953).

25 *Id.* at 428.

26 Berle, The Price of Power: Sale of Corporate Control, 7 Corp. Practice Commentator 321 (1966).

right.[27] In the absence of a cumulative voting arrangement or other modifying provisions of a shareholders' agreement each shareholder is entitled to cast as many votes as the number of shares he owns.[28] If this voting procedure is followed, the majority shareholders will elect each and every director. When there are minority interests involved, however, there are two basic voting procedures which may be used to insure them representation on the board.

Cumulative voting, a statutory creation,[29] allows each shareholder to cast a total number of votes equal to the number of shares he owns multiplied by the number of directors to be elected.[30] These votes may be used in any manner the shareholder desires. He may cast them all for one candidate or he may split them among several.[31] When cumulative voting is used, representation on the board normally is split roughly proportionately to the voting strength of the shareholders.[32] Besides giving the minority a voice on all director action, representation on the board affords them an opportunity to keep abreast of corporate activities.[33]

When only a small number of directors are to be elected, either because the total board membership is small or the directors serve staggered terms,[34] cumulative voting may be of no benefit. In order for the minority to have representation on the board, the initial capitalization must consist of two classes of stock. Representation on the board would be determined by each class of stock voting independently.[35]

Even if a minority holder has representation on the board, he may have no control over the board's actions if the members representing the majority can always, by acting together, control the passage or defeat of a resolution. Minority interest, then, desires some veto power over board action. If the shareholders' agreement provides that all board action will require a unanimous vote, minority interests are well protected.[36] Realistically, if such an agreement is upheld, the minority interests could use that power in an unreasonable manner to the extent of rendering the corporation completely inflexible.[37]

Alternatively the shareholders' agreement may provide that a high percentage vote, short of unanimity, be required on all action,[38] or better

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[27] *Ibid.*

[28] State v. Gray, 20 Ohio App. 26, 153 N.E. 187 (1925).

[29] *In re* Brophy, 13 N.J. Misc. 462, 179 A. 128 (1935).

[30] Grange & Woodbury, *op. cit. supra* n. 8 at 163.

[31] White, Pace Business Law Series, Unit IV, Law of Corporations (1959).

[32] Williams, Cumulative Voting for Directors 6 (1951).

[33] *Id.* at 136.

[34] *Id.* at 141.

[35] White, *op. cit. supra* n. 31 at 77.

[36] O'Neal, *op. cit. supra* n. 2.

[37] *Id.* at 164; Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E. 2d 829 (1945).

[38] *Ibid;* See also, 1 Oleck, Modern Corporation Law 200 (1958, with 1965 supp.).

yet, that a unanimous or high percentage vote be required on any issue which directly affects interests of minority holders.[39] In this manner, the ability of the corporation to adjust to changing circumstances would still exist without giving substantial interests the power to dictate corporate policy.[40]

A primary function of the board of directors is to elect officers who will carry on routine operations of the corporation. As protection for shareholders, who become the officers of the close corporation, long-term employment contracts may be established.

Provisions of those contracts can be as varied as the provisions of the shareholders' agreement itself. Usually the corporation covenants that it will retain the named employee at a specified salary.[41] More sophisticated provisions can include periodic increases in salary either in a stated amount, as a percent of profits, or in a fixed proportion to salaries of other corporate officers.[42] Inherent in any such contract is the provision that the terms of the agreement will only apply so long as the officer continues to be loyal and act in good faith towards the corporation.[43]

As long as directors are not deprived of their right and duty to exercise independent judgment, the shareholders' agreement may establish reasonable standards for the board to follow in deciding whether or not to declare a dividend. The agreement may provide that earnings or accumulated profits of the corporation must reach a set level before the directors would be empowered to vote for a distribution.[44] This type of provision is most important where minority interests are involved, as the withholding of dividends can often be an effective way of squeezing minority interests out of the corporation.[45]

Even though the agreement calls for dividends to be paid when surplus or current year's earnings reach a specified level, there should be some discretion vested in the board to pass a dividend if, in their judgment, the corporation requires the working capital to conduct day to day business or to meet an expected contingency.[46] The need to protect certain interests should not override the need to be flexible and operational, but creditors may require that no dividends be paid until their loans

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39 *Ibid.*

40 *Ibid.*

41 Wilson v. McClenny, 262 N.C. 121, 136 S.E. 2d 569 (1964).

42 O'Neal, *op. cit. supra* note 2 at 163.

43 *In re* Burkin, 1 N.Y. 2d 570, 154 N.Y.S. 2d 898, 136 N.E. 2d 862 (1956); Fells v. Katz, 256 N.Y. 67, 175 N.E. 516 (1931).

44 Grange & Woodbury, *op. cit. supra* note 8 at 163; Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E. 2d 482 (1939).

45 O'Neal, *op. cit. supra* n. 2.

46 *Ibid.*

have been repaid.[47] A similar provision can be used to assure stockholders, who have lent money to the corporation, of repayment in preference to dividend distributions.

Many small business corporations reach a point of impasse because directors or major shareholders cannot agree on what action is to be taken in a particular situation. A well-conceived plan should contemplate this problem. The shareholders can contract among themselves that if such an impasse is encountered, they will all vote their shares in favor of a complete dissolution of the corporation.[48] It is wise to provide, however, that if a deadlock does occur, the corporation or the other shareholders are given a first option to purchase the dissenters shares.[49] If the shareholders are equally divided so that identification of a dissenter is impossible, the agreement may provide that between the two sides one will buy and the other will sell their shares at a specified price.[50]

Arbitration agreements can be very effective in preventing dissolution. Where directors or major shareholders cannot agree on a course of action, the agreement can provide that independent arbitrators are to be called in and their judgment respected.[51] Alternatively, independent managers can be hired to take charge of the business while the principals reconsider their positions over a predetermined period of time.

Election of directors, director resolutions, dividend policies, election and salaries of officers and issues of an unusual nature such as dissolution are, then, the main areas in which voting rights are significant. The shareholders' agreement can, within legal limitations, determine how these issues will be resolved.

There are three devices which can be used to assure voting in a prescribed manner. The voting trust, pooling agreement and proxy arrangement all can be used to insure the continuation of control in one or more persons. Each of these devices has its advantages and disadvantages, and the effective use of each depends on the circumstances and objectives to be attained. The shareholders' agreement at the creation of the corporation may establish the device, or it may be put into operation at a later date. Although each agreement has its unique legal aspects, generally, the validity of each will stand or fall on factors already discussed.

The simplest of these methods is the pooling agreement. Basically, it is a simple, joint voting contract in which shareholders bind themselves to vote in a predetermined manner.[52]

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[47] Hart v. Bell, 222 Minn. 69, 23 N.W. 2d 375 (1946).

[48] Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E. 2d 20 (1944).

[49] Logan, Methods to Control the Closely Held Corporation, 7 Kan. L. Rev. 405, 442 (1959).

[50] O'Neal, *supra* n. 2 at 159.

[51] Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A. 2d 441 (1947).

[52] O'Neal, *op. cit. supra* n. 17 at § 5.03.

A proxy may also play a role in the control of a small business corporation. Basically, a proxy is an authorization given by the legal owner of corporate shares to another person to enable the latter to vote the shares.[53] Legal title is not transferred although the certificates may be deposited with an escrow or proxy holder to assure that the shares will not be transferred to a purchaser who is unaware of the agreement, and not bound by it.

Unless coupled with an interest, the proxy is revocable at any time, and if no time is specified in the agreement, most states provide that the proxy will lapse after a statutorily stated time.[54]

Terms of the proxy agreement will determine the scope of power granted to the proxy holder. He may be given the power to vote the shares only at a single meeting or at all meetings. Limitations on the scope of the proxy holder's power may take the form of a provision requiring him to vote for specified persons or in a specified manner on certain issues. By use of the proxy, shareholders can be sure that all shares will be voted in a prescribed manner.[55]

The third and the most complicated voting device is the voting trust. This method, of the three, is most jealously guarded in creation and operation by state statutes. Trust operation is initiated when the shareholders transfer legal title to their shares to a trustee who, unlike the proxy holder, acts as the principal owner rather than a mere agent. In return for legal title, the original shareholders are given trust certificates as evidence of beneficial ownership. Unless limited by agreement, the trustee can vote the shares in any manner and for any purpose he desires and may be authorized to sell or otherwise dispose of the stock.

Limitations as to the term of a voting trust are found in almost every state.[56] A time limitation tends to reduce the usefulness of a trust as a device for effecting a permanent separation of ownership and control,[57] although some statutes allow a renewal of the term. Ideally, the term of a voting trust, while meeting statutory limits, should be commensurate with the length of time needed to meet the objectives of the controlled vote.

Use of a voting trust by a small corporation is usually thought of as a part of a salvage operation.[58] A financially weak corporation often uses the device to insure potential investors or creditors of control over the

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[53] Grange & Woodbury, *op. cit. supra* n. 8 at 166.

[54] White, *op. cit. supra* n. 31 at 75.

[55] Grange & Woodbury, *supra* n. 8 at 166.

[56] Sturdy, The Significance of "Form and Purpose" in Determining the Effectiveness of Agreements Among Stockholders to Control Corporate Management, 13 Bus. Law. 283 (1958).

[57] Cavitch, Ohio Corporation Law, § 4.51 (1966).

[58] Grange & Woodbury, *op. cit. supra* n. 8 at 169.

operations of the corporation while their money is being used to strengthen the corporate position. Contrary to this belief, the voting trust can be used by a financially healthy corporation whose holders wish to carry out some definite plan.[59] For example, if the holders agreed to change the major endeavor of the corporation, they might create a voting trust to insure voting on all issues which will bring about the desired change.[60]

Participation in a voting trust usually must be available to every member of the class of stock involved, and all shareholders have the right to inspect the agreement.[61] Validity of the trust depends, further, on the purpose for which it was created. It cannot be used to defeat minority interests or to allow shareholders to exercise powers which belong to the board of directors. Officers and directors should not be made trustees, but the use of shareholders as trustees is permissible and oftentimes encouraged.[62] Duties of the trustee should be clearly spelled out as should limitations on their power to sell, vote a merger or consolidation or to buy the stock themselves. Any profits derived from dealing in these stocks should be reserved to the corporation.[63]

While the pooling agreement seems to represent the simplest and most satisfactory of the three at initial formation of the corporation, either a proxy or voting trust will serve more effectively if the need arises later in corporate life. An attempted use of a pooling agreement or proxy may fail if it appears, in substance, to be a voting trust in non-compliance with statutory regulations.[64] The voting trust best fits the situation when investors or creditors desire control, but because of its complications, it may be undesirable. Besides having to conform to statutory requirements, the transfer of title to shares might be subject to state or federal regulations.[65] In addition, once the original shareholder becomes a mere beneficial owner, he is a legal stranger to the corporation and in danger of losing the rights normally possessed by a shareholder.[66]

Buy-Sell Agreements

One of the advantages which businessmen seek when choosing the corporate form is continual existence of the entity. Unlike the partnership, the death or other departure of an owner does not, in any case, necessitate by law a dissolution of the entity. The departure of a share-

59 Bergman, Voting Trusts and Non-Voting Stock, 37 Yale L. J. 445 (1927).

60 Cavitch, *op. cit. supra* n. 57.

61 DeMarco v. Paramount Ice Corp., 102 N.Y.S. 2d 692 (Sup. Ct. 1950); Henn, Law of Corporations 317 (1966).

62 Adams v. Clearance Corp., 35 Del. Ch. 459, 121 A. 2d 302 (1956); Holmes v. Sharretts, 228 Md. 358, 180 A. 2d 302 (1962).

63 O'Neal, *op. cit. supra* n. 17 at § 5.33.

64 Abercrombie v. Davies, 130 A. 2d 338 (Del. Sup. Ct. 1957).

65 Sturdy, *op. cit. supra* n. 56 at 287.

66 Henn, *op. cit. supra* n. 61.

holder, however, may result in a dissolution if proper plans were not made.

Although the legal requirement of free transferability of corporate shares and the needs of the corporation seem to be irreconcilable, they are not. Through a buy-sell agreement the shareholders may agree that there be reasonable partial restrictions on their right to transfer shares if the restriction serves a valid purpose.[67]

There are two basic prerequisites to a valid restriction. First, the restriction must be derived from a source of corporate power.[68] Normally, a charter or bylaw provision will be sufficient. Secondly, the restriction must be reasonable.[69] Size of the entity, degree of restraint to be imposed, length of time the restraint is to last and the best interests of the corporation should be examined in determining reasonableness.[70]

The usual form of a lifetime restriction is the first option or first refusal type. Depending on the plan adopted either the corporation or remaining shareholders are given a first option to buy the shares of the departing shareholder. A lifetime restriction can also take the form of a consent restriction through which the board of directors or other shareholders must approve an attempted transfer to an outsider.[71] In theory, under this plan, there need be no accumulation of funds in anticipation of such transfer as the approved buyer will simply replace the departing shareholder.[72] Legally, this type of restriction can lead to litigation if it is felt that in substance the restriction is an absolute one.[73] The right of first refusal provision is just as effective as the consent restriction and is less cumbersome.

The restrictions mentioned so far are not effective to accomplish the desired results at the death of a shareholder. In anticipation of that event, the provision should be a mandatory one. The shareholder should direct in his will that the sale be made as specified in the buy-sell agreement.[74]

A buy-sell agreement must provide that full value will be paid for the shares and at the same time assure continued proportionate control in the remaining shareholders. Upon a voluntary departure, a shareholder should be bound by a covenant not to compete within a reason-

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[67] Greene v. E. H. Rollins & Sons, Inc., 22 Del. Ch. 394, 2 A. 2d 249 (1938); Bloomingdale v. Bloomingdale, 107 Misc. 646, 177 N.Y.S. 873 (Sup. Ct. 1919). For forms, see 5 Oleck, Modern Corporation Law, Forms 469-471 (1965 supp.).

[68] Cataldo, Stock Transfer Restrictions and the Close Corporation, 37 Va. L. Rev. 229 (1951).

[69] Allen v. Biltmore Tissue Corp., 2 N.Y. 2d 534, 141 N.E. 2d 812 (1957).

[70] 106 Tax Management, Corporate Buy-Out Agreements A-48 (1965).

[71] 106 Tax Management, *op. cit. supra* n. 70 at A-11.

[72] *Ibid.*

[73] Hornstein, *op. cit. supra* n. 19 at 1040.

[74] Davis, Life Insurance and Business Purchase Agreements 26 (1963).

able time after the severance and within a reasonable geographic area.[75] That same shareholder should also be protected by a general release from all past and future liability on credit given to the corporation but guaranteed by the individual officers. As a further protection the shareholder should be given the right to be indemnified in the event he does become liable for such debts.[76]

Two types of agreements serve to accomplish the objectives stated above. The first type is the stock redemption, or stock retirement plan. It is also known as the entity plan, as the corporation becomes the purchaser of the available shares. If the procedure under which the corporation accumulates the necessary funds to purchase the stock is life insurance, the policy on each shareholder is usually owned by the corporation which pays the premiums and is the beneficiary. In order to keep the arrangement as simple as possible, one policy should be purchased for each shareholder.[77] These policies become assets of the corporation and their presence on the corporate balance sheet, in the amount of the cash surrender value, may provide added security to a potential creditor. Conversely, being an asset of the corporation, a creditor can attach these policies as any other asset can be attached.[78]

This plan eliminates the need to pay the insured shareholders, who normally are the officers of a close corporation, a higher salary so that they may pay the premiums. The premium payments however are not tax deductible expenses to the corporation. Depending on the relative tax brackets of the shareholders and the corporation, it might be more economical from a tax viewpoint, to pay higher salaries which do constitute deductible expense to the corporation, and have the shareholders pay the insurance company. There is the possibility, however, that the Internal Revenue Service might treat the increase in salary as a dividend distribution.[79]

The second type of agreement is the cross-purchase plan. Here, the remaining shareholders buy the shares of the deceased, disabled or otherwise departing shareholder. If the agreement is funded by life insurance, each shareholder usually owns and is the beneficiary of a policy on the life of another. When there are several shareholders to be protected, the ownership of the policies and the distribution of premium payments can become quite complicated and premium payments dispro-

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[75] Levin, Implied Covenants Against Competition Created by Transactions in Corporate Stock: Some Thoughts on Tobin v. Cody, 43 Boston Univ. L. Rev. 20 (1963).

[76] Ackerman, A Guide to Some Pitfalls of Business 13 (1957).

[77] Guild, Stock-Purchase Agreements and the Close Corporation 18 (1960).

[78] *Id.* at 21.

[79] Diamond Life Bulletins, Tax Facts on Life Insurance 61 (1967).

portionate because of age and physical differences.[80] It may be advantageous to have each insured purchase the policy on his own life or refund to the holder of the policy on his life any excess premium payments required to be made.[81]

The ability of the shareholders to pay the premiums must be considered in choosing the cross-purchase plan. It is possible, but very unwise, to have the corporation pay premiums as these payments undoubtedly will be given dividend distribution treatment. It is also possible to raise the salaries of the shareholders, and this is the way it is usually done. A third possibility does exist, however, and is often the best solution to the problem of who should pay the premiums. Under a split dollar plan the corporation can purchase a whole life or endowment policy on each shareholder to be covered by the agreement. The corporation owns the policy but the shareholders pay a portion of the premium. The corporation's share of the premium is equal to the yearly increase in the cash surrender value of the policy. Since the cash surrender value increases each year and the total premium payment remains constant, the shareholders' portion will be a falling factor. At the time the proceeds are paid to the shareholder's beneficiary in return for the stock of the deceased, the corporation would be entitled to the amount of cash surrender value built up to that time. The cost to the corporation is, in the long run, completely recovered.[82]

A trustee may be used in connection with the cross-purchase plan. The trustee becomes the beneficiary of the policies and holds the shares to insure that a smooth transfer will occur at the proper time. The plan assures prompt performance and completion of the transaction and can insulate the policies and, in fact, the shares themselves from corporate and personal creditors.[83]

No matter which plan is chosen, there are several problems which must be solved before the agreement can be completed and effective. The first of these is how to fund the agreement. The most common funding method is insurance, and it is most advisable to consult an expert in this regard. Oftentimes, the corporation and the individual shareholders do not feel that they can afford the premiums to obtain the necessary coverage. There are some techniques for solving this problem which should be considered, such as to purchase the least expensive insurance,

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[80] Sexton, Providing Security for the Outgoing Stockholder and Avoiding Tax Disadvantages to Selling and Remaining Stockholders, N.Y.U. 24th Inst. on Fed. Tax 555, 556 (1966).

[81] Schwartz, Will Your Business Die With You?, 32 #5 Harv. Bus. Rev. 110, 121 (1954).

[82] Mehr & Osler, Modern Life Insurance 431, 432 (1961 3rd ed.); Brosterman, The Complete Estate Planning Guide 74 (1964).

[83] Guild, *op. cit. supra* note 77 at 28; Bowe, Estate Planning and Taxation 371 (Chartered Life Underwriter Ed. 1961).

e.g., term insurance. This protection could be carried until such time as corporate earnings reached a level where whole life or endowment policies could reasonably be afforded.[84] If needed, borrowed funds can be used to purchase the insurance, and while at first glance it seems a poor way to accomplish the objectives of funding, it does have many advantages which should not be discounted without proper analysis of the overall picture.[85] The use of life insurance, of course, has both its advantages and limitations. Most assuredly, the buy-out will be conducted smoother and faster if life insurance is the funding medium than if other methods were used. Further, the accumulation of funds will be done without subjecting the earnings on those funds to the payment of income taxes during the accumulation period.[86] Life insurance, on the other hand, will be of no help if a shareholder wishes to make a lifetime disposition of his stock nor will pure life insurance aid in the situation of a disabled shareholder or at a retirement. An endowment policy can be most useful in the latter case, but the use of installment payments will best accomplish the objectives of a disability buy-out.

Although life insurance is not the proper funding method for a disability contingency, health insurance can be used along with installment payments to accomplish the buy-sell.[87] It has been suggested by Messrs. Harmelin and Friedman in one of the very few articles on this subject, "Disability Insurance in the Business Buy-Out Agreement",[88] that the proper way to fund the agreement in anticipation of a disability contingency is through noncancelable health insurance which will be used to make up part of each installment payment. They further recommend that life insurance which builds cash surrender value should also be maintained so that it may be used at the time the health insurance benefits expire. The definition of disability used in the buy-sell agreement should coincide with that used in the insurance policy so that there will be no debate as to whether or not a shareholder is, in fact, disabled.

Installment payments can be used exclusively to fund the agreement if it can reasonably be expected that the corporation or the shareholders, depending on the arrangement, will have the liquidity needed to consummate the transaction. If this method is used, a question as to when title to the stock should pass arises. Possibly the seller could transfer a portion of the stock each time an installment is made, but this does not preclude the transferor from exercising the voting rights of his remaining shares. Possible voting controversies, therefore, have not been elimi-

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[84] Schwartz, *op. cit. supra* n. 81 at 120.

[85] *Ibid.*

[86] P-H Corporations, § 1171 (1965).

[87] Harmelin & Friedman, Disability Insurance in the Business Buy-Out Agreement 31 (1965).

[88] *Ibid.*

nated. The issuance of another class or series of stock in exchange for the voting stock to be acquired over the installment period seems to be a reasonable way of avoiding these controversies. Nonvoting stock in the hands of the heirs or departing shareholder would entitle them to continue receiving dividends over the buy-out period, but would limit them from interfering with the smooth operations of the corporation.[89]

Installment payments out of corporate surplus or from the personal assets of the shareholders can also be an effective means of completing a buy-out when life insurance is used, but the proceeds are not expected to cover the amount needed to purchase the shares for full value.[90]

Corporate surplus may be used to effect the buy-out, but unless surplus is sufficient immediately upon executing the agreement and is reasonably expected to be sufficient at all times, hence, it appears to be a mistake, to say the least, to rely upon future accumulated earnings. A small growing corporation, although it may show considerable surplus shortly after beginning operations, usually isn't in a very liquid position. That is, surplus is not a measure of cash and only cash or other very liquid assets can satisfy a seller.

Once the choice of plan has been made and the funding problem recognized the next imperative step is to determine the price or method of determining the price at which the shares will be purchased. Hopefully, there will be a long lapse of time between the execution of the agreement and the time at which it becomes operational. Therefore, a problem immediately arises. As of what date should the stock be valued?

The agreement could set a permanent value on the shares at the time the contract was executed, but this would be a very narrow pessimistic approach. More realistically, the agreement should provide for a valuation to be ascertained as of the date of death or other departure of the shareholder, or provide for a periodic review so that when the contingency arises, a valuation will have been made recently. The latter alternative seems to be the most advantageous from the standpoint of determining the adequacy of the funding arrangement and in educating the shareholders as to just what their business is really worth.

Once the valuation date has been established, the shares must be valued. The choice of the valuation technique is one the shareholders should make, and the intent here is only to present basics of several plans.

The first method which comes to the businessman's mind is book value. The basic consideration here is one of adequate accounting.[91] Even if generally accepted accounting principles are used consistently,

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[89] 106 Tax Management, *op. cit. supra* n. 70 at A-18; 48 Tax Management, Installment Sales A-61 (1965).

[90] Harmelin & Friedman, *op. cit. supra* n. 87.

[91] Guild, *op. cit. supra* n. 77 at 31.

there are still numerous other problems to consider. Should goodwill be valued and included in the share valuation? If it is decided to do so, it would seem proper to ascertain the value of goodwill lost to the corporation by the departure of the shareholder and to reduce the price the corporation must pay by that amount.[92] Goodwill being an intangible asset is hard to value as are patents and the like.

An independent appraisal is a second available method of valuation. It should be done at intervals to be effective, but it can be very expensive. It is feasible for the shareholders to evaluate the assets of the business themselves and only seek the opinion of the independent appraiser if at one of the periodic reviews they fail to agree on a value.[93] Reliance on the appraisal method to determine the fair buy-sell price of the shares of a small corporation may have a serious drawback if it fails to consider the existence and value of goodwill.[94]

An appraisal can be used in connection with a third method, the capitalization of earnings. Under the capitalization method, earnings of what are determined to be average years are multiplied by a price-earnings factor considered proper for the type and size of the particular business. When the appraisal method and the capitalization method are combined, the value of the stock is represented by the sum of the appraised tangible assets plus goodwill.[95] Goodwill is represented by the difference between the expected profits of the particular corporation and the average return on the type and amount of assets as if there was no goodwill.[96]

The answers derived from the above computation or from the capitalization method are only as good as the basic assumptions upon which the computations are made. Which are the average earning years? At what rate should earnings be capitalized? What is a normal rate of return on assets such as the corporation possesses? Some guesswork is inevitable, but if done by competent persons at stated intervals, the shareholders will be well informed of their worth.

It is important that all possible contingencies be recognized in drafting the agreement. No doubt death will be the first to be recognized and planned for. Disability[97] will probably be the last to be thought of despite the fact that the possibility of disability usually is greater than the possibility of death at the ages of those beginning a business.

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92 P-H Corporations, *op. cit. supra* n. 86 at § 1174.

93 P-H Corporations, *op. cit. supra* n. 86.

94 106 Tax Management, *op. cit. supra* n. 70 at A-15.

95 P-H Corporations, *op. cit. supra* n. 86.

96 Siddel, Stock Purchase Agreements Between Stockholders and Their Corporation, 43 Taxes 306 (1965).

97 Harmelin & Friedman, *op. cit. supra* n. 87.

Internal dissension, too, is an opportune moment to effectuate the provisions of a buy-sell agreement.[98] Dissolution can be avoided by buying out the dissenting shareholder at the time the irreconcilable difference arises. Retirement and the voluntary withdrawal of a shareholder should also be covered by the agreement.

It cannot be repeated too often that the circumstances must dictate the provisions of any agreement, but I have compiled a checklist which may be helpful in drafting a buy-sell agreement.

1. Determine the contingencies at the happening of which the agreement will become operational. Death, voluntary withdrawal, disability, internal dissension and retirement should all be considered.
2. Determine how the agreement is to be funded. Remember that the funding arrangement must adequately meet the contingency to be covered. A combination of funding methods might be necessary.
3. Determine how the shares are to be valued and provide for periodic revaluations.
4. Determine what type of arrangement is to be used. Who is to own the policies? Who is to pay the premiums? Who is to receive the proceeds? These are primarily tax considerations.
5. Determine the type of restriction to be placed on transferability. Match the restriction with the contingency. Will local law allow it?
6. Make sure all proper persons and entities are parties to the agreement.
7. Provide for termination and amendment of the agreement at the happening of certain named events.

Tax Considerations

From the moment the corporation is chosen as the business form, the potential shareholders must be keenly aware that their plans must be developed with tax consequences in mind. Taxes, however, should not be the only reason for selecting a certain plan. There may be overriding factors such as designed control procedures, smooth functioning of the business or buy-sell agreements, which can only be accomplished by forsaking some possible tax savings. A complete explanation of all the tax ramifications of a control agreement would be far beyond the scope of this article. Therefore, the discussion here will be limited to the basic problems to be resolved and a short nontechnical approach to each.

Control, as the word has been used so far, has meant the ability to direct corporate action either by owning and voting a majority of the stock or by combining voting power through an agreement. Control has

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[98] *In re* Astey, 19 Misc. 2d 1059, 189 N.Y.S. 2d 2 (Sup. Ct. 1959).

a different meaning under the Internal Revenue Code and becomes important in determining whether transfers of assets to the corporation constitute a taxable or nontaxable event.[99] Basically, the elements of a tax free transfer are:

1. Stock or securities must be received in return for the property transferred to the corporation.
2. The transferor(s) must, immediately after the transfer, own at least 80% of the total voting stock.
3. They must own at least 80% of the total shares of all other stock.

Although the elements appear relatively simple, numerous problems can arise. Many of these are definitional. For example, what constitutes property,[100] what are securities,[101] and what is voting stock?[102]

The purpose of introducing this provision of the tax code is merely to put the drafter of the control agreement on guard. Normally, the creation of a close corporation will automatically qualify for tax free treatment as the group of transferors will more than meet the 80% requirements and normally receive only stock in return.

The election to be taxed as a *Subchapter S* corporation will affect the way in which control is distributed. In order to elect and maintain this preferential tax treatment, the corporation may not issue more than one class of stock. Control arrangements in which the issuance of nonvoting common or preferred stock must be forsaken in favor of debt securities or a wider distribution of control. Even the use of a voting agreement might have the effect of destroying *Subchapter S* treatment, as it has been held that such agreements, in substance, create a second class of stock when less than all voting shares are involved.[103]

Basically, *Subchapter S* treatment allows a corporation to be taxed as a partnership. All profits whether distributed or not are taxed to individual shareholders at their individual rates. The relative tax brackets of the shareholders and the corporation will be the economic factors to consider when determining the advisability of electing *Subchapter S* treatment. From a business standpoint, the election may be disadvantageous if the tax savings are gained at the expense of lost control and/or additional equity financing.

Problems in *Subchapter S* taxation do not end with qualifying for the election initially. If through a subsequent sale or bequest of a shareholder's interest, the total number of shareholders exceeds ten, the elec-

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[99] Int. Rev. Code of 1954, § 351; 54-2d Tax Management, Transfers to Controlled Corporations A-13 (1963).

[100] 101 Tax Management, *op. cit. supra* note 5 at A-7.

[101] *Id.* at A-8; Commissioner v. Neustadt's Trust, 131 F. 2d 528 (2nd Cir. 1942).

[102] 54-2nd Tax Management, *op. cit. supra* n. 99.

[103] Treas. Reg. § 1.1371-1(g) (1963).

tion will be lost. Careful drafting of a buy-sell agreement can eliminate that possibility.

Besides consideration of *Subchapter S* taxation, initial issuance of stock and securities can be influenced by other tax considerations. The advantages of debt financing are obvious. Interest payments are deductible to the corporation whereas dividends are not. Interest payments must be reasonable for if the debt is, in the Internal Revenue's estimation, really equity, the interest payments will be treated as dividends. That is not to say that a shareholder may not be a creditor of the corporation. The basic determination of the allowability of interest deductions is the overall debt-equity ratio—a subject in and of itself.[104]

The repayment of a loan, normally, is a nontaxable event as compared to the redemption of stock which often leads to tax consequences. The former may, however, be treated as a taxable event if the debt is regarded as being equity capital. The use of debt financing may have the further advantage of providing a sufficient reason for accumulation of earnings over the level at which excess profits tax would be invoked if the obligation to repay was not present.[105] Debt securities may also provide the basis of a gift program whereby older shareholders, wishing to divest themselves of some of their assets for estate tax purposes, but retain their proportionate control of the corporation, can give these secuties.[106]

The use of preferred stock, while giving no tax advantages to the corporation, can be valuable to the shareholders as a possible method of getting earnings out of the corporation at capital gains rates. Although this possibility has been limited by new provisions of the code,[107] issuance of preferred stock at the beginning of corporate life may still yield the desired results when the shares are redeemed later on.[108] On the other hand, preferred stock financing usually is more expensive than debt financing simply because the return to the investor on preferred stock must be made with after-tax dollars.[109] Interest payments, conversely, are deductible expenses.

In the discussion of buy-sell agreements no emphasis was placed on the consideration of who should own and maintain the insurance policies used to fund the agreement. These decisions are affected by tax considerations.

Premium payments both under cross-purchase and redemption plans are not deductible either to individual shareholders or to the corpora-

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[104] Smith, Effects of Taxation—Corporate Financial Policy 156 (1952).

[105] *Id.* at 158.

[106] 101 Tax Management, *op. cit. supra* n. 5 at A-28.

[107] Int. Rev. Code of 1954, § 306.

[108] 101 Tax Management, *op. cit. supra* n. 5 at A-20.

[109] Smith, *op. cit. supra* n. 104 at 17-44.

tion.[110] On the other hand, the proceeds of the policies are not normally included in gross income. Taxation problems most often arise in determining whether or not premium payments by the corporation are, in fact, dividend distributions to shareholders.

When the corporation owns, and is the beneficiary of a life insurance policy under a redemption plan, the premiums paid by the corporation are not considered to be dividends to a shareholder. If the beneficiary of such a policy is a shareholder, the premiums might be given dividend treatment. The result is not clear, however, as it has been held that if the shareholder may choose the beneficiary, premiums may not be dividends if the corporation has the remainder of the incidents of ownership of the policy, and the beneficiary's right to the proceeds only occurs upon a transfer of the stock to the corporation.[111]

Premium payments by the corporation pursuant to a cross-purchase plan will be treated either as additional compensation to the shareholders or as a dividend. If the determination is made that premiums were additional compensation, the corporation will be entitled to a deduction in the amount of the premium payments. If, however, premium payments cause the compensation being received by shareholders to be unreasonable in light of earnings or size of the corporation, they will be treated as dividends.[112]

When a trustee has been appointed to receive the proceeds of the policies and to administer the buy-sell, premium payments made by the corporation will probably not be treated as a dividend distribution.[113]

The cross-purchase plan represents the simplest buy-sell arrangement for tax purposes. The redemption plan has many tax aspects to consider. As the insurance policies build cash surrender value the accounting effect is to increase the surplus of the corporation. Under the Internal Revenue Code, a tax, at an extremely high rate, is imposed upon excess accumulations of surplus over that which the business can reasonably justify. Although the accumulated cash surrender values may not reach a point where the excess profits tax would become a possibility, if the corporation sets aside funds each year to pay premiums in future years or builds a sinking fund to make installment payments, the excess profits tax becomes a real consideration.[114]

There has been no decisive ruling on whether the future obligation to redeem a shareholder's interest constitutes a reasonable accumulation

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110 Bowe, *op. cit. supra* n. 83 at 370; Int. Rev. Code of 1954, § 264.

111 Diamond Life Bulletins, Tax Facts on Life Insurance 60 (1967); Prunier v. Commissioner, 248 F. 2d 818 (1st Cir. 1957).

112 Diamond Life Bulletins, *op. cit. supra* note 111 at 61; Yuengling v. Commissioner, 69 F. 2d 971 (3rd Cir., 1934).

113 Doran v. Commissioner, 246 F. 2d 934 (9th Cir. 1957).

114 106 Tax Management, *op. cit. supra* n. 70 at A-30; 35-2nd Tax Management-Accumulated Earnings Tax A-49 (1966).

of surplus, but at least one authority believes that such an accumulation would constitute a "strong defense against an effort to impose the penalty tax on accumulations made to fund that obligation." [115]

Unless the redemption is one in complete liquidation of a shareholder's stock, there is danger that the profit on the redemption may be taxed as ordinary income. Since stock is a capital asset, capital gains treatment will normally be accorded the complete redemption. When the redemption is a partial one, however, the code provides that gain will be treated as ordinary income.[116] If this were not the case, shareholders under a preconceived plan of partial redemptions could turn ordinary income, accumulated earnings and profits, into capital gains by merely redeeming a portion of their stock. When redemptions are made pro rata, the shareholders retain their proportionate control.

There are three exceptions to the partial redemption rule. Capital gains treatment will be accorded the redemption if it is a disproportionate one,[117] that is that the shareholder has less than 80% of the stock which he owned before, and his ownership of voting power is less than 50% of the total.[118] In determining the percent requirements, stock owned by the shareholder's spouse, children, parents or grandchildren must be considered.[119]

If the shareholder's stock which is redeemed constituted a substantial part of his estate, the redemption will be treated as an exchange and qualify for capital gains treatment.[120] Substantial is considered to be more than 35% of the gross estate or, alternatively, 50% of the net taxable estate.[121] Dividend treatment, however, will still be accorded any profit on the redemption over and above the death taxes, funeral costs and administrative expenses payable by the estate.[122]

The disproportionate redemption may be utilized in the case of a lifetime transfer, but the redemption to pay death taxes, obviously, only applies at the death of a shareholder.

Another exception to the partial redemption rule is a partial liquidation. This exception will not ordinarily be available to a close corporation, for to be applicable there must be a real reduction in the corporation's scope of business as a result of the redemption.[123]

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115 106 Tax Management, *op. cit. supra* n. 70 at A-33.

116 Int. Rev. Code of 1954, § 301, § 316; 17-2nd Tax Management-Corporate Stock Redemption A-3 (1965).

117 Int. Rev. Code of 1954, § 302.

118 Int. Rev. Code of 1954, § 302(b)(2).

119 Int. Rev. Code of 1954, § 318(a)(1); Siddell, *op. cit. supra* note 96; 72 Tax Management-Constructive Ownership Rules under § 318 (1963).

120 Int. Rev. Code of 1954, § 303.

121 *Ibid.*

122 Siddel, *op. cit. supra* n. 96.

123 Int. Rev. Code of 1954, § 346; 106 Tax Management, *op. cit. supra* n. 70 at A-33.

Use of a stock redemption plan, then, requires tax expertise in its planning an operation.

A primary advantage to the cross-purchase plan is that when the remaining shareholders acquire the stock of the deceased or otherwise departing shareholder, their basis in the newly acquired stock is roughly what they paid for it. The total amount of each one's equity in the corporation will be spread over a much higher basis in the stock they own than if the corporation redeemed the shares of the departing shareholder. Capital gains at a subsequent sale will, therefore, be considerably lower.

Under either plan the heirs of the deceased shareholder will receive favorable tax treatment for the sale of the shares. The basis of the stock in their hands is the fair market value at the date of death. If the agreement provided for a reasonable price and the price would have been available upon a lifetime transfer as well as at death, the agreement will set the estate tax value of the shares and the basis of these shares to the heirs.[124]

Caution

Caution must be exercised in drafting the shareholders agreement. Local law, both statutory and case law, must be examined. A valid exercise of shareholder control in one state is not necessarily valid in another. Further, the reader is cautioned to recognize that beyond terms of an agreement between shareholders, charter and bylaw provisions must be drafted to enable the corporation to proceed as the shareholders desire.

There must be a balancing of the objectives in each provision of the agreement. Business, tax, control and overall shareholder and corporate objectives require consideration. Teamwork among the shareholders and experts in each area to be covered is a necessity.

Most basic to creating a workable agreement is the function of planning. Realism is the key to adequate planning. Consideration should be given to possible, not only probable, contingencies which might arise. The plan, however, must be flexible. An amendment properly timed can forestall otherwise disastrous consequences.

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[124] Lomb v. Sugden, 82 F. 2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F. 2d 682 (2d Cir. 1932).