University of Baltimore Law Review

Volume 6
Issue 1 *Fall 1976*

Article 2

1976

Statutory Incorporation Flexibility in Maryland: Drafting Corporate Documents for the Privately-Held Enterprise

Ronald M. Shapiro
University of Baltimore School of Law

STATUTORY INCORPORATION FLEXIBILITY IN MARYLAND: DRAFTING CORPORATE DOCUMENTS FOR THE PRIVATELY-HELD ENTERPRISE

Ronald M. Shapiro†

The provisions of the Maryland Code governing the incorporation process enable the attorney incorporating a privately-held enterprise to draft corporate documents accommodating the needs of the particular promoting individuals. This article focuses on the drafting of articles of incorporation and bylaws, and places particular emphasis on the options for allocating control and financial interests available within the Maryland statutory framework.

I. INTRODUCTION

The provisions governing corporations in general[1] contained in the Corporations and Associations Article of the Maryland Annotated Code offer a wide variety of options for planning the incorporation of a business entity.[2] In order to acquaint clients interested in forming a corporation with the range of options available to them under the Code, and to guide and implement their decisions intelligently, it is essential that counsel have a thorough understanding of the statutory provisions that govern the incorporating process. Central to corporate planning are decisions concerning the allocation of control and of financial interests in the enterprise. The two primary corporate organizational documents — the articles of incorporation and the bylaws — substantially embody these decisions, and thus together function as

† B.A., Haverford College, 1964; J.D., Harvard University, 1967; Partner, Shapiro & Sachs, P.A.; Lecturer, University of Baltimore and University of Maryland Schools of Law.

The author gratefully acknowledges the assistance of Elizabeth G. Newcomb, Articles Editor, University of Baltimore Law Review.

1. MD. ANN. CODE, Corp. & Ass'ns Art., §§ 1-101 to 3-520 (1975), *as amended*, (Supp. 1976) [hereinafter sometimes referred to as the "Code"].
2. This article is limited to those provisions applicable to a privately-held corporation organized under the general corporations provisions of the Code. It will cover those situations where the group of individuals who intend to organize a corporation are few in number (three or four) and wish each member to obtain equal stock interest and a position on the board of directors. The focus is so limited because the overwhelming number of incorporation problems faced by the general practitioner arise out of such privately-held organizations. For those who have used the MD. ANN. CODE, Corp. & Ass'ns Art., Title Four (1975), Close Corporation form for such groups, *see* Shapiro, *The Statutory Close Corporation: A Critique and a Corporate Planning Alternative*, 36 MD. L. REV. — (1977).

a vitally important agreement delineating the rights and obligations of the stockholders and directors of the corporation. Too often, however, the "drafting" of these documents is accomplished through mechanical repetition of provisions contained in a "form set." The benefits of tailoring documents to the characteristics and objectives of a particular promoter group is sacrificed for the convenience of adopting what has been used before.

There is a wide variety of choices available for the allocation of control and the delineation of financial interests. The "control" spectrum ranges from tilting the scales of corporate control heavily in favor of an incumbent board of directors to according minority stockholders far-reaching veto rights. Financial interests can be apportioned equally by conferring dividend and liquidation rights to all stockholders on the same basis, or the apportionment can favor one individual or stockholder group by the allocation of such rights on a preferred basis to that individual or group of stockholders.[3] In order to advise clients competently as to what arrangements would best accomplish their objectives, and to fulfill the attorney's responsibility in planning and drafting articles of incorporation and bylaws for a privately-held corporation,[4] the general practitioner must be thoroughly familiar with the Code options.

The purposes of this article are (1) to acquaint the non-corporate specialist with the statutory provisions governing incorporation and (2) to demonstrate the benefits of "tailor-made" corporations over "form corporations." Sample articles of incorporation and bylaw provisions will be included to demonstrate practical corporate planning points.[5]

3. At the initial stages of pre-incorporation planning, counsel should consider the potential for conflicts of interest and the advisability of having varying interests in a prospective enterprise represented by different counsel during the process of drafting organizational documents.

4. For the purposes of this article, the author has adopted Professor F. Hodge O'Neal's recent definition of a "close" or "privately-held" corporation:

> The term 'close corporation' has been defined in various ways. It is often used to distinguish and set apart the corporation with only a few shareholders from the 'public issue' or publicly-held corporation. Another popular definition states that a close corporation is a corporation whose shares are not generally traded in the securities market. One of the few judicial definitions says that the term means 'a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling.'

F. HODGE O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 1.01, at 2 n.1 (1975).

5. Certain forms set forth in this article are adapted from R. SHAPIRO & A.R. SACHS, MARYLAND CORPORATE FORMS — PRACTICE (1976).

II. ARTICLES OF INCOPORATION: MANDATORY PROVISIONS

The filing of articles of incorporation[6] with the State Department of Assessments and Taxation[7] and acceptance of the articles by the Department are prerequisites to the formation of a *de jure* corporation in Maryland.[8] Corporate existence commences when the Department accepts the articles for record.[9] Filing improperly drawn articles can cause unnecessary delay in achieving corporate status,[10] and more importantly, raises the spectre of defective incorporation, which can result in the loss of the limited liability generally achieved through corporate status.[11] The danger of defective incorporation can easily be avoided by careful attention to those matters required by the Code to be included in articles of incorporation.[12] Thus, although more planning time will be spent

6. The articles of incorporation are hereinafter sometimes referred to as the "charter" or "articles." The term "charter" as used in the Code not only includes the articles of incorporation, but also, *inter alia*, amended articles of incorporation, articles of amendment, and articles of restatement. MD. ANN. CODE, Corp. & Ass'ns Art., § 1-101(e) (Supp. 1976).
7. The Maryland State Department of Assessments and Taxation is hereinafter sometimes referred to as the "Department."
8. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-102(a)(2) (filing) and § 2-102(b)(1) (acceptance) (1975).
9. *Id.* § 2-102(b)(1).
10. If the articles do not satisfy applicable requirements, then a Department official will return the articles to the incorporator for revision.
11. Loss of limited liability may be avoided by successful assertion of either the doctrine of incorporation by estoppel or de facto corporation. While it is clear that the more limited doctrine of incorporation by estoppel is recognized in Maryland, *see* Cranson v. International Business Machs. Corp., 234 Md. 477, 200 A.2d 33 (1964), there is some doubt as to the viability in this State of the doctrine of de facto corporation. *See id.*, and Note, *Liability Under Defectively Organized Corporations*, 26 MD. L. REV. 354 (1966).
12. The mandatory charter provisions are enumerated in MD. ANN. CODE, Corp. & Ass'ns Art., § 2-104(a) (1975), and are as follows:
    (1) The name and address of each incorporator and a statement that each incorporator is: (i) 18 years or older; and (ii) Forming a corporation under the general laws of the State of Maryland;
    (2) The name of the corporation;
    (3) The purposes for which the corporation is formed;
    (4) The address of the principal office of the corporation;
    (5) The name and address of the resident agent of the corporation;
    (6) (i) The total number of shares of stock of all classes which the corporation has authority to issue; (ii) The number of shares of stock of each class; (iii) The par value of the shares of stock of each class or a statement that the shares are without par value; and (iv) If there are any shares of stock with par value, the aggregate par value of all the shares of all classes;
    (7) If the stock is divided into classes as permitted by § 2-105 of this subtitle, a description of each class including any preferences, conversion

evaluating the effects of and choosing optional charter provisions,[13] the mandatory provisions should not receive summary treatment.

The provisions required by the Code to be included in the articles, and the major considerations attendant to the drafting of such provisions, are as follows:

(1) *The name and address of the incorporator and a statement that he or she is over 18 and incorporating under Maryland law.*[14] The incorporator should be distinguished from the common law promoter. The promoter is the instigating force behind the organization of the corporation,[15] while the incorporator's statutory function is only to provide the Department with a name and a set of articles for filing. For that scintilla of time after filing but before an organizational board meeting is held, the incorporator has the power to revise the articles by preparing and filing amended articles of incorporation.[16] Generally, for convenience, counsel drafting the articles is designated to hold this position.

(2) *Corporate name.*[17] In addition to indicating corporate status by traditional symbols,[18] the corporate name must not be preempted by or misleadingly similar to that of another corporation registered or qualified to do business in Maryland, and must not indicate a corporate purpose other than that stated in the charter.[19]

---

and other rights, voting powers, restrictions, limitations as to dividends, qualifications, and terms and conditions of redemption; and

(8) The number of directors and the names of those who will serve as directors until the first annual meeting and until their successors are elected and qualify.

13. *Id.* § 2-104(b) and § 2-105.
14. *Id.* § 2-104(a)(1).
15. The Maryland Court of Appeals has said in defining a promoter:

    [I]n a comprehensive sense 'promoter' includes those who undertake to form a corporation and to procure to it the rights, instrumentalities and capital by which it is to carry out the purposes set forth in its charter, and to establish it as fully able to do its business.

    Crosse v. Callis, 263 Md. 65, 72, 282 A.2d 86, 89 (1971), *citing* Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 177, 89 N.E. 193, 201 (1909).
16. Amended articles of incorporation may be filed by the incorporator(s) prior to the organizational meeting of the board of directors, provided there is no stock outstanding or subscribed for. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-603(a) and (b) (1975). If stock is outstanding or subscribed for, the proposed amendment must be initiated by adoption of a resolution by the board of directors, and must be submitted to the stockholders for their approval. *Id.* § 2-604. The document filed with the Department to evidence the latter, more formal procedure is referred to as "articles of amendment." *Id.* § 2-607 (Supp. 1976).
17. *Id.* § 2-104(a)(2).
18. Corporate status may be indicated by inclusion in the name of the words "corporation," "incorporated," "limited" or abbreviation of one of these words, or inclusion of the word "company," if not immediately preceded by "and" or a symbol therefor. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-106(a) (Supp. 1976).
19. *Id.* § 2-106(b). There is, however, no statutory prohibition against the use of a name that is misleadingly similar to that of an unincorporated enterprise.

In order to prevent preemption during the period of corporate organization, the Code permits the reservation of a specific qualifying name for a period of thirty days by forwarding to the Department a signed application and a nominal fee.[20]

(3) *Statement of corporate purposes.*[21] Since broad general powers are automatically accorded Maryland corporations by the Code,[22] it is unnecessary to reiterate these powers in the articles. Nevertheless, a general description should be included, setting forth the type of business in which it is expected the corporation will engage.[23] In order to authorize expansion of operations to fields of endeavor beyond those initially contemplated, one of the stated corporate purposes might also provide that the corporation may "engage in any other lawful business."

There may be times, however, when counsel must prepare provisions that narrow the statutory powers in order to comply with special Code or non-corporate law requirements. For example, a non-profit corporation seeking tax-exempt status must be restricted to very limited purposes and powers to satisfy. Internal Revenue Code requirements respecting such a corporation.[24]

(4) *Address of principal office of the corporation.*[25]

(5) *Name and address of resident agent.*[26] In contrast to the incorporator, the resident agent must be a Maryland corporation or a Maryland citizen residing in the State.[27] Some counsel recommend themselves as resident agent. Others, however, prefer to name a stockholder of the corporation because of the possibility that the corporate client may later engage counsel other than the attorney organizing the corporation.

(6) *The total number of shares of authorized stock and a statement of its par value (and the aggregate value thereof) or that the stock has no par value,*[28] and

20. *Id.* § 2-107(b).
21. *Id.* § 2-104(a)(3).
22. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-103 (1975), *as amended,* (Supp. 1976).
23. *Id.* § 2-104(a)(3).
24. INT. REV. CODE OF 1954, § 501(c) and regulations thereunder. Other corporations which require adherence to special statutory provisions respecting the statement of purpose or similar matters include: non-stock corporations, MD. ANN. CODE, Corp. & Ass'ns Art., § 5-201 to 5-208 (1975), *as amended,* (Supp. 1976), professional service corporations, *id.* § 5-101 to 5-122 (1975), *as amended,* (Supp. 1976), and statutory close corporations, *id.,* Title 4 (1975), *as amended,* (Supp. 1976).
25. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-104(a)(4) (1975).
26. *Id.* § 2-104(a)(5).
27. *Id.* § 2-108(a)(2).
28. *Id.* § 2-104(a)(6)(iii).

(7) *If there are classes of stock, a description of each class.*[29] Many of the vitally important aspects of stock authorization are governed by optional provisions relating to the allocation of control and financial interests and are considered below.[30] Nevertheless, because the par value or a statement that authorized stock is without par value must be set forth in the articles, an initial choice must be made between authorization of par and no par stock. The choice of no par stock accords the board of directors maximum flexibility in making an allocation between stated capital and capital surplus,[31] and thus permits a build-up of capital surplus. Capital surplus, in turn, contributes to the total surplus of the corporation, which provides the funds necessary to implement certain corporate transactions such as the declaration of dividends[32] and repurchase of stock.[33] In the case of a privately-held corporation, authorization of 5,000 shares of common stock without par value, the maximum number of shares of no par stock for the minimum bonus tax, should provide adequate authorized stock for issuance to its several stockholders.[34]

(8) *Number and names of initial directors.*[35] The persons named as the initial directors of the corporation are vested with the authority to direct the management of the corporation until the first annual meeting or such other time as their successors are duly chosen and qualify.[36] While, at this writing, at least three directors must be named for a general corporation, statutory reform has been sought to permit a minimum of one director in Maryland general corporations.[37]

29. *Id.* § 2-104(a)(7).
30. *See* text accompanying notes 44-54 *infra.*
31. If stock is issued with par value, only that consideration received in excess of the aggregate par value constitutes capital surplus, while any portion of the consideration received from stock without par value may be allocated to capital surplus by the board prior to the issuance of such stock. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-303(a) and (b) (1975).
32. *Id.* § 2-309(b) and (c).
33. *Id.* § 2-311(d).
34. The choice of no par stock may result in a slightly higher bonus tax than stock of low par value, because for bonus tax purposes no par stock is deemed to have a value of $20 per share. MD. ANN. CODE art. 81, § 194(b) (1975). This disadvantage is minimal, however, as the bonus tax is relatively nominal in either case. (For example, the present bonus tax on 10,000 shares authorized with $1 par value is $20, and the bonus tax on the same number of shares with no par value is $40. *Id.* § 194(a).)
35. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-104(a)(8) (1975).
36. *Id.* § 2-404(a). In a privately-held corporation, it is generally desirable to name the same number of directors as there are stockholders.
37. The author considers such statutory reform a salutory alternative to the problems inherent in statutory (Title Four) close corporations and a device for eliminating "dummy" or "straw" directors. *See* Shapiro, *The Statutory Close Corporation: A Critique and a Corporate Planning Alternative,* 36 MD. L. REV. ___ (1977).

An example of provisions setting forth only mandatory charter matters follows:

> FIRST: I, ..., whose post office address is ....., ..., ..., being at least eighteen (18) years of age, do hereby form a corporation under and by virtue of the General Laws of the State of Maryland.
>
> SECOND: The name of the corporation (which is hereinafter called the "Corporation") is ABC, INC.
>
> THIRD: The purposes for which the Corporation is formed are:
>
> (1) [Include a general summary purpose of business to be pursued]; and to engage in any other lawful purpose and/or business.
>
> (2) To do anything permitted by Section 2-103 of the Corporations and Associations Article of the Annotated Code of Maryland, as amended from time to time.
>
> FOURTH: The post office address of the principal office of the corporation in the State is ....., Maryland. The name and post office address of the Resident Agent of the Corporation in this State are ....., Maryland. Said Resident Agent is a [Maryland citizen actually residing in this State.] [Maryland corporation.]
>
> FIFTH: The total number of shares of capital stock which the Corporation has authority to issue is ..... (.....) shares of common stock without par value. [If shares with par value, the aggregate of the par value of all authorized shares must be stated.]
>
> SIXTH: The number of directors of the Corporation shall be ..... (.....), which number may be increased or decreased pursuant to the bylaws of the Corporation, but shall never be less than three (3). The names of the directors who shall act until the first annual meeting or until their successors are duly chosen and qualified are: ..... .

III. ARTICLES OF INCORPORATION: PERMISSIBLE PROVISIONS

Coverage of the mandatory charter matters set forth above is sufficient to satisfy prerequisites to acceptance of the articles for recording by the Department.[38] Nevertheless, to plan a privately-

38. *See* text accompanying notes 6–11 *supra.*

held corporation involving two to four stockholders that is flexible enough to account for unexpected future occurrences, yet structured enough to preserve the initial stockholders' basic intentions, the optional charter provisions of the Code must be effectively utilized. Tremendous flexibility is available since the articles may contain virtually any lawful provision deemed desirable. In two successive provisions of the Code,[39] the corporate planner is conveniently

39. The permissible charter provisions are enumerated in MD. ANN. CODE, Corp. & Ass'ns Art., § 2-104(b) and § 2-105 (1975), which state:

§ 2-104(b) *Permissible provisions.* — The articles of incorporation may include:

(1) Any provision not inconsistent with law which defines, limits, or regulates the powers of the corporation, its directors and stockholders, any class of its stockholders, or the holders of any bonds, notes, or other securities which it may issue;
(2) Any restriction not inconsistent with law on the transferability of stock of any class;
(3) Any provision authorized by this article to be included in the bylaws;
(4) Any provision which requires for any purpose the concurrence of a greater proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose;
(5) A provision which requires for any purpose a lesser proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose, but this proportion may not be less than a majority of all the votes entitled to be cast on the matter;
(6) A provision which divides its directors into classes and specifies the term of office of each class; and
(7) A provision for minority representation through cumulative voting in the election of directors and the terms on which cumulative voting rights may be exercised.

§ 2-105. Charter provisions relating to capital stock. A corporation may provide by its charter:

(1) For one or more classes of stock, the voting rights of each class, and any restriction on or denial of these rights;
(2) As to each class of stock, either the par value of the shares or that the shares are without par value;
(3) (i) That the corporation shall set apart dividends for or pay dividends to the holders of a specified class of stock before any dividends are set apart for or paid to the holders of another class of stock; (ii) The rate, amount, and time of payment of the dividends; and (iii) Whether the dividends are cumulative, cumulative to a limited extent, or noncumulative;
(4) That any specified class of stock is preferred over another class as to its distributive share of the assets on voluntary or involuntary liquidation of the corporation and the amount of the preference;
(5) That any specified class of stock may be redeemed at the option of the corporation or of the holders of the stock and the terms and conditions of redemption, including the time and price of redemption;
(6) That any specified class of stock is convertible into shares of stock of one or more other classes and the terms and conditions of conversion;
(7) That the holders of any specified securities issued or to be issued by the corporation have any voting rights or other rights which, by law, are or may be conferred on stockholders;
(8) For any other preferences, rights, restrictions, including restrictions on transferability, and qualifications not inconsistent with law;
(9) That the board of directors may classify or reclassify any unissued stock from time to time by setting or changing the preferences,

provided with a list of available options which should be considered carefully with any group of individuals contemplating incorporation, in much the same manner as potential provisions in a partnership agreement are reviewed with prospective partners.[40] In preparing the corporate charter, counsel should explain to clients the ramifications of each permissible provision. The drafting of optional charter provisions centers around two major considerations: allocation of control and delineation of financial interests in the corporation.

A. Allocation of Control

The primary means for allocating control is through optional charter provisions governing the manner in which members of the board of directors are to be elected. If no such provisions are included, board of director elections will be determined by the statutory principle of majority rule.[41] This principle, if unqualified, allows a stockholder or stockholders owning a bare majority of the issued and outstanding voting stock of the corporation to elect the entire board of directors.[42] If, on the other hand, a group of stockholders agrees that, without regard to majority stock ownership, each stockholder should have representation on the board, or that a minority stockholder should have at least one representative on the board, counsel can achieve either of these objectives through inclusion of provisions in the charter eliminating majority rule, or tying it to some limiting device such as a voting trust agreement.[43]

The most direct method for allocating board representation among various stockholders is to designate classes of stock in the charter[44] and to provide that the holders of each class of stock

---

conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, or terms or conditions of redemption of the stock;

(10) For any definition, limitation, or denial of the preemptive rights of stockholders to acquire additional stock in the corporation.

40. *See* note 3 *supra.*

41. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-506(a)(2) (1975).

42. This result assumes that all the shares entitled to vote are cast for the election of directors. Otherwise, even fewer stockholders could elect the entire board, as the Code provides:

> A majority of all the votes cast at a meeting at which a quorum is present is sufficient to approve any matter which properly comes before the meeting.

Id. § 2-506(a)(2).

43. For a discussion and examples of voting trust agreements, *see* SHAPIRO & Sachs, *supra* note 5, ch. 5, form 5.3.4; Woloszyn, *A Practical Guide to Voting Trusts,* 4 U. BALT. L. REV. 245 (1975).

44. *See* MD. ANN. CODE, Corp. & Ass'ns Art., § 2-105(1) (1975), which authorizes use of classes of stock. It should be noted that the use of classes of stock as a control device may preclude certain tax options, such as the election to be a Subchapter S corporation under the Internal Revenue Code, INT. REV. CODE OF 1954, § 1371, unless the classes are carefully structured so that their right to

will be entitled to elect a designated class of directors.[45] For example, the charter of a corporation comprised of three stockholders desiring an equal voice on the board of directors without regard to their relative percentages of stock ownership could provide:

> The total number of shares of capital stock that the Corporation has authority to issue is five thousand (5,000) divided into two thousand, five hundred (2,500) shares of Class A Common Stock without par value, two thousand (2,000) shares of Class B Common Stock without par value, and five hundred (500) shares of Class C Common Stock without par value.
>
> The following is a description of each class of stock of the Corporation with the preferences, conversion and other rights, restrictions, voting powers, and qualifications of each class:
>
> 1. Except as hereinafter provided with respect to the election of the Board of Directors of the Corporation, the Class A Common Stock, the Class B Common Stock, and the Class C Common Stock of the Corporation shall be identical in all respects and for all purposes, and the holders of Class A Common Stock, the holders of Class B Common Stock and the holders of Class C Common Stock, voting together and without distinction as to class, shall be entitled to one (1) vote in all proceedings in which actions shall be taken by the stockholders of the Corporation.
>
> 2. With respect to the election of the Board of Directors of the Corporation:
>
> (1) the holders of Class A Common Stock (a) shall nominate and elect one (1) director who shall be known as the Class A Director, and (b) in the event of the death, disability, removal, resignation or refusal to act of the Class A Director, the holders of Class A Common Stock, to the exclusion of the holders of all other classes of stock of the Corporation, shall nominate and elect one (1) director to fill the vacancy so created by such death, disability, removal, resignation or refusal to act; and
>
> (2) the holders of Class B Common Stock (a) shall nominate and elect one (1) director who shall be known as the Class B Director, and (b) in the event of the death, disability, removal, resignation, or refusal to act of the Class B Director, the holders of the Class B Common Stock, to the exclusion of the holders of all other classes of stock

elect members of the board of directors is proportionate to the number of shares in each class. *See* Treas. Reg. § 1.1371-1(g) (1968) and cases decided thereunder.

45. *See* MD. ANN. CODE, Corp. & Ass'ns Art., § 2-104(b)(6) (1975), which authorizes use of classes of directors.

of the Corporation, shall nominate and elect one (1) director to fill the vacancy so created by such death, disability, removal, resignation or refusal to act; and

(3) the holders of Class C Common Stock (a) shall nominate and elect one (1) director who shall be known as the Class C Director, and (b) in the event of the death, disability, removal, resignation, or refusal to act of the Class C Director, the holders of the Class C Common Stock, to the exclusion of the holders of all other classes of stock of the Corporation, shall nominate and elect one (1) director to fill the vacancy so created by such death, disability, removal, resignation or refusal to act.

The number of directors of the Corporation shall be three (3). The names of the directors who shall act until the first annual meeting of the stockholders of the Corporation or until their successors are duly chosen and qualified and the class of Common Stock which they represent are:

Class A Director: Class B Director: Class C Director:

Such a provision, coupled with issuance of one class of stock respectively to each of the three stockholders, assures all of the stockholders the representation on the board of directors to which they have agreed. The model "classes of stock — classes of directors" provision can be tailored to the needs and numbers of an individual stockholder group in a given corporation.[46]

Although classification of stock and directors will implement the desired balance of power, additional provisions are necessary to ensure its maintenance.

Since the purpose of this classification provision is to allocate control among all stockholders without regard to majority stock ownership, it should be protected from possible extinction by an amendment which could be passed by a vote of less than all the stockholders. To avert this danger, counsel should insert a provision prohibiting amendment of the classification provision without unanimous approval by vote of all shares entitled to be cast thereon.[47]

46. The number of directors to be elected by the holders of the various classes of stock may be varied to satisfy any specified situation. For example, a minority class of stock may be assured of electing one director, or a fifty per cent stockholder may be given the right to elect two-thirds of the directors in accordance with his importance in managing the enterprise. In such cases, the classes of common stock are generally identical in all respects except with respect to board of directors election.

47. Although the Code provides that stockholders shall approve any charter amendments by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter, MD. ANN. CODE, Corp. & Ass'ns Art., § 2-604(d) (1975), the Code also allows this two-thirds requirement to be varied down to a bare majority

Dilution of an individual stockholder's control of a class of directors can also be avoided by limiting the future issuance of stock. This can be accomplished by a charter provision requiring unanimous approval of either the board of directors[48] or the stockholders[49] for stock issuance.

The above discussion illustrates the importance of including in the charter not only provisions designed to effect the immediate result desired, but also provisions which shelter that result from future unintended erosion.

An alternative device for accomplishing minority stockholder board representation is cumulative voting.[50] The usefulness of the cumulative voting device, however, is diminished because it requires the use of a mathematical formula which may be annoying to stockholders,[51] and because it does not permit the precision of allocation among three or more groups that can be achieved through the use of classes of stock. These shortcomings are due to the fact that cumulative voting was conceived to assure minority representation rather than to divide representation among divergent interests within the corporation.[52]

A third means of allocating the power to elect members of the board of directors is through use of non-voting stock.[53] A class of voting stock can be issued to those stockholders who will actively manage the business, and a class of non-voting stock to other stockholders. The usefulness of this device may be limited practically to situations where there are two groups of interests who agree that one is to be accorded control.

---

of all votes entitled to be cast, and up to unanimity. *Id.* § 2-104(b)(4) and (5). Further, if classes of stock are selected as a control device, the Code appears to build in protection for each class by its reference to the required vote of "all classes or of any class;" since the Code is not clear as to whether the requirement is two-thirds of each class or two-thirds of all the stock outstanding and entitled to vote, drafting unanimous vote requirements further protects the desired balance of corporate control.

48. *Id.* § 2-204(b)(1) and (2), in conjunction with § 2-104(b)(4).
49. *Id.* § 2-204(b)(3), in conjunction with § 2-104(b)(4). Utilizing preemptive rights as an alternative to the provisions referred to in the text at this and the preceding footnote is unsatisfactory in view of the substantial statutory qualifications on preemptive rights. *See id.* § 2-205.
50. *Id.* § 2-104(b)(7).
51. Professor Henn sets forth the following formula for determining cumulative voting:

$$X = \frac{Y \times N}{N + 1} + 1$$

X = Number of votes needed to elect each director
Y = Total number of shares voting at meeting
N = Number of directors to be elected

See H. HENN, CASES AND MATERIALS ON THE LAWS OF CORPORATIONS 321 (1974).

52. *See* H. HENN, LAW OF CORPORATIONS § 189, at 365 (1970).
53. The use of non-voting stock is indirectly authorized by MD. ANN. CODE, Corp. & Ass'ns Art., § 2-105(1) (1975).

The above alternatives demonstrate various methods available for electing the board of directors. The choice of the most suitable device marks the first step in allocating control in the privately-held corporation; the second step is delineating the board's power to direct management of the corporation.[54]

In drafting these limitations and qualifications on the board's power, counsel should focus on two areas of board action: those matters on which board action is required by the Code, and those matters not governed by particular Code provisions but which fall within the general authority of the board to direct corporate management.

The most prominent matters upon which board action is statutorily required are stock issuance,[55] the declaration of dividends,[56] the election and removal of corporate officers,[57] and the initiation of extraordinary corporate matters, including charter amendments, which ultimately require stockholder approval.[58]

Absent a charter or Code provision to the contrary, the "action of a majority of the directors present at a meeting at which a quorum is present is the action of the board of directors."[59] The statute thus allows adjustment of the board's management power through variation of the majority rule principle or the proportion of members required to constitute a quorum, or both. While failure to adjust either the required vote or the quorum percentage may produce results which are neither desirable nor anticipated,[60] adjustment of the voting requirement alone may be equally insufficient to effectuate the desired balance of board power.[61] Counsel must consider the combined effect of voting and quorum requirements.

Generally, the board vote required to act on a particular matter should increase with the importance of that matter to the organiz-

54. *Id.* § 2-104(b)(1).
55. *Id.* § 2-203(a)(1). For a discussion of unanimity and stock issuance requirements, *see* text accompanying notes 30 & 40 *supra*.
56. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-309(a) (1975).
57. *Id.* § 2-413(a) (election) and (c) (removal). The right of the board of directors to elect officers is subject to variation by charter or bylaws provision. *Id.* § 2-413(a).
58. *Id.* § 3-105(b) (consolidation, merger, or transfer of assets), *id.* § 3-403(b) (voluntary dissolution), and *id.* § 2-604(b) (charter amendment).
59. *Id.* § 2-408(a).
60. Failure to modify the statutory language could give even less than a majority of board members the power to take board action. For example, if the board consists of eight members, a quorum is five. *Id.* § 2-408(b)(1). A mere majority of the quorum (three persons) can act for the entire board. *Id.* § 2-408(a).
61. If the vote required for board action is raised to unanimous action of a duly constituted meeting but the quorum is not changed from a majority of the board, *id.* § 2-408(b)(1), a mere majority of board members can still act for the entire board.

ing stockholders. For example, there is the possibility that a conflict will arise between individual stockholder desires for dividends and management's view that the corporation should retain earnings. Stockholders alerted to this possible conflict may, in the initial planning stages, decide that the corporation's need to use the earnings for continued corporate growth is to prevail over individual desires. In this case, the declaration of dividends should be subjected to a higher or even unanimous director vote requirement.[62]

A similar analysis must be made in connection with each area in which the Code requires board action.[63] Once prospective stockholders understand the implications behind the decisions, they can decide which of their individual needs in each area should, in the corporate interest, be subject to board control. Counsel then can readily draft a combination of appropriate charter and bylaw provisions to implement these decisions.

As a further illustration, the stockholders in a privately-held enterprise are often also its officer-employees. Because the board of directors is statutorily charged with the election and removal of corporate officers,[64] charter provisions should be included that protect stockholder-officers' job security by qualifying the board's power over employment matters. Three stockholders equally involved in organizing a new corporation might feel adequately protected after executing long-term employment contracts.[65] Nevertheless, the position of each as a corporate officer might be jeopardized by the failure to include unanimous quorum and voting requirements for removal of officers. If an unforeseen conflict between the board and a stockholder-officer should later develop, he or she could be removed by a simple majority vote of directors at a meeting at which a quorum is present.[66] A charter or bylaw

62. For example, it may be recognized upon incorporation that the corporation has substantial projected capital needs to insure its growth. In order to sustain such needs, stockholders may agree that dividends ought to be severely curtailed even if such curtailment might deleteriously affect their personal financial circumstances at a later date.

63. *See* text accompanying notes 55–58 *supra,* for reference to other matters with respect to which such voting standards are altered.

64. MD. ANN. CODE, Corp. & Ass'ns Art., § 2–413(a) (1975).

65. Long-term employment contracts can be authorized by permitted variation of the statutory one year term for corporate officers. *Id.* § 2–413(b). This statutory provision should be compared with challenges historically leveled at long-term employment contracts on the theory that they "bind the hands of future boards of directors." 2 W. FLETCHER, ENCYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 336 (rev. ed. 1964).

66. Although such removal does not eliminate the individual's right to contract damages, MD. ANN. CODE, Corp. & Ass'ns Art., § 2–413(c)(2) (1975) the absence of adequate protection can result in a squeeze-out from all corporate control of

provision designed to obviate such potential corporate conflict could provide:

> The President and Vice-Presidents of the Corporation shall serve for a term of years, which may exceed one year, as set forth in their agreements of employment with the Corporation and until their respective successors are elected and qualified.
>
> Any action by the Board of Directors respecting the removal of the President or the Vice-Presidents of the Corporation shall be taken only by unanimous approval of the entire Board of Directors.

If it is desirable that officer removal be more easily attainable, the vote required for such removal could accordingly be adjusted downward.

Carefully drafted provisions establishing the procedures by which the board of directors is elected and board action is effectuated will resolve major control problems in an entity in which the members of the board and the stockholders are identical. If, however, there are more stockholders than members of the board, counsel should consider protection of those stockholders not on the board by adding provisions requiring stockholder approval of board actions not statutorily or traditionally subject to such approval, and varying the stockholder vote when it is statutorily required.

The Code grants substantial latitude in drafting provisions that accord stockholders a degree of involvement in what traditionally have been considered director management decisions.[67] Imposition of stockholder approval, for example, might be advisable when the stockholders want the right to approve the election of officers, the issuance of stock, or the repurchase of stock.[68]

---

one individual by others in a privately-held corporation. This potential is particularly evident when only three or four stockholders control the corporation, as those same individuals will also serve as corporate officers and sit on the board of directors.

67. Recent court decisions in Maryland and other jurisdictions show a judicial readiness to abandon the traditional prohibition against stockholder invasion of board management powers. Under these decisions, such stockholders' protective provisions will be upheld unless they totally preempt the board's management function. *See, e.g.*, DeBoy v. Harris, 207 Md. 212, 113 A.2d 903 (1955), and Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

68. All of these are areas which are traditionally within the board of directors' control, but which nevertheless may be subjected to stockholder approval through the "unless otherwise provided" language of the Code. *See* MD. ANN. CODE, Corp. & Ass'ns Art., 2-413(a) (1975) (election of officers), *id.* § 2-204(b)(2) (stock issuance), and *id.* § 2-310(a) (repurchase of stock).

An example of such a provision follows:

> The following provisions are hereby adopted for the purpose of defining, limiting, and regulating the powers of the Corporation and of the directors and stockholders thereof:
>
> With respect to:
>
> (a) the issuance of shares of stock of any class now or hereafter authorized, or any securities exchangeable for, or convertible into such shares, or warrants or other instruments evidencing rights or options to subscribe for, or otherwise acquire such shares;
>
> (b) the redemption by the Corporation of shares of its own stock or the purchase or other acquisition by the Corporation of its own shares;
>
> (c) the purchase by the Corporation other than in the ordinary course of business, of property and assets at a cost equivalent to or greater than fifty percent (50%) of the net worth of the Corporation as reflected on the balance sheet most recent to the date of such purchase;
>
> (d) the amendment of any employment agreement, or the alteration of the terms set forth therein, as shall be entered into between the Corporation and _____;
>
> (e) the making of any loans or advances by the Corporation other than to employees and suppliers in the ordinary course of business;
>
> and notwithstanding any provision of law authorizing any action to be taken or authorized other than as provided in this Article, after due authorization and approval and advice of such actions by the Board of Directors as required by law, any such action shall be effective and valid only if approved by the stockholders by an affirmative vote of a majority [or other designated number] of the votes entitled to be cast thereon.

The second type of protective provision varies the stockholder vote statutorily required to approve such matters as charter amendments, mergers, share exchanges, consolidations, transfers of assets, partial liquidations and dissolutions. These matters are effectuated by the "affirmative vote of two-thirds of all the votes entitled to be cast"[69] on the matter, absent a relevant charter provision. In practice, while control of the election of the board of directors and its power to direct management is frequently vested

69. *See id.* § 2-604 (charter amendment), *id.* § 3-105 (mergers, share exchanges, consolidations, transfer of assets), *id.* § 3-301 (partial liquidation), and *id.* § 3-403 (dissolution). A corporation may be dissolved by the incorporators if such action is taken prior to the organizational meeting of the board of directors. *Id.* § 3-402(b).

in stockholders actively involved in the operation of the business, these "extraordinary" matters are frequently the subject of charter provisions that accord significant vetoes to the minority and passive stockholders by increasing the statutory vote otherwise required to effectuate these decisions. For example, stockholders who fear they may be "squeezed out" by one or more of the above extraordinary corporate acts[70] can protect themselves by requiring a high or unanimous stockholder vote for approval of such actions.

On the other hand, there may be decisions for which the needs of the individual enterprise dictate majority rather than two-thirds stockholder approval without regard to minority interests. For example, an individual who is the moving force in the organization of a corporation may wish to retain for him or herself control over implementation of extraordinary corporate actions. Such an individual may organize a corporation with others who agree that he or she should have virtual control of the enterprise but who, as the minority group, desire to retain forty-nine percent of the equity. Such fifty-one percent stock ownership would give the majority stockholder control over the election of directors and certain other stockholder matters. Yet, because of the statutory two-thirds vote requirement, he or she could not control the vote on extraordinary matters, discussed immediately above, unless the charter specified that certain extraordinary corporate matters could be implemented by approval of a majority of the shares entitled to be cast thereon. This reduction of the statutory two-thirds vote required for approval of charter amendments and extraordinary matters enhances management flexibility by making the vote required of stockholders more proportionate to the percentage of stock owned by management.

Other provisions which expand the management control of a particular stockholder's interest are charter provisions giving the board the right to adopt, alter or repeal the bylaws. This right is otherwise statutorily vested in the stockholders.[71] Similarly, charter provisions can eliminate the rights of stockholder dissent and of a fair appraisal remedy, assertable with respect to a charter amendment which substantially adversely affects the contract rights of a stockholder.[72] Such provisions can reduce the potential finan-

70. For a discussion of "squeeze-outs" of minority stockholders, *see* F. HODGE O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS (1975).
71. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-109(b) (1975).
72. *Id.* § 3-202(a)(3). The stockholders may be deprived of their fair appraisal remedy only in connection with charter amendments, and not in connection with other extraordinary corporate acts.

cial burden on a corporation that alters or abolishes any preferential right, any redemption right, or any preemptive rights accorded outstanding stock, or that creates or alters restrictions on the transferability of such stock, or excludes or limits the voting rights of such stock.[73] The following sample provision in the charter would accomplish this result:

> The Corporation reserves the right to amend its Charter so that such amendment may alter the contract rights, as expressly set forth in the Charter, of any outstanding stock, and any objecting stockholder whose rights may or shall be thereby substantially adversely affected shall not be entitled to the same rights as an objecting stockholder in the case of a consolidation, merger, share exchange, or transfer of substantially all of the assets of the Corporation.

Another expansion of management authority can be accomplished by a charter provision authorizing the board of directors to classify or reclassify unissued shares of stock.[74] Such a provision permits the board, without stockholder approval, to change preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, or terms or conditions of redemption of authorized but unissued stock. Otherwise, each of these actions can be accomplished only by charter amendment, which must be submitted for stockholder approval.[75]

As the Code commentators have stated,[76] before the codification of preemptive rights in Maryland, there was uncertainty as to when stockholder preemptive rights applied. The Code Revision Commission attempted to resolve some of this uncertainty by enumerating the circumstances in which a stockholder is *not* entitled to such rights.[77] Nevertheless, uncertainty remains and impairs the discretion of the board to issue stock at times and on terms it deems to be in the best interests of the corporation. To eliminate as much of this uncertainty as possible and to allow full board discretion, a provision should be included in the charter expressly negating preemptive rights unless the board specifically implements them for a particular issuance of stock.[78] The board

73. These matters are generally viewed as the type of "contract rights" that are the subject of the dissenting stockholder's fair appraisal remedy.
74. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-105(9) (1975).
75. *See id.*, § 2-208, which sets forth the procedure followed when the board has received the requisite authorization. Under this provision, articles supplementary must be filed with the Department. *Id.*
76. *See* comment that follows *id.* § 2-205.
77. *Id. See also id.* § 2-205 for the circumstances under which preemptive rights do not accrue.
78. *See id.* § 2-105(10), which authorizes such a provision.

is thus relieved of the duty of analyzing whether preemptive rights would otherwise apply to a given issuance, and yet is free to create such rights if the interests of the corporation so dictate.

The array of charter provisions discussed in this section demonstrates the scope of planning and drafting options available to counsel in allocating control among the stockholders of a privately-held corporation.

B. Allocation of Financial Interests

Although most early planning discussions and drafts will center around basic decisions concerning the management and control of the corporation, counsel may also need to draft charter provisions affecting various financial interests within a group of potential stockholders. Discussion of methods of capitalizing new enterprises is beyond the scope of this article.[79] Some basic matters, however, deserve mention by way of introduction. Initial decisions as to the desired debt-equity ratio[80] and other preliminary tax matters[81] should be made by counsel working closely with accountants retained by the incorporating group. Once it has been determined how much of the initial capital of the corporation will be in the form of equity, counsel has wide latitude in setting up the structure of capital stock to reflect the needs and expectations of the organizing stockholders. The most useful structuring approach is to accord preferences and rights among various classes of stock. This task is simplified by the checklist of possibilities set forth in the Code itself.[82]

The classic example of the organization of a new privately-held corporation involves three stockholders. One stockholder makes a substantial investment of cash in the enterprise, another transfers substantial assets to be utilized in the operation of the business, and a third makes a nominal tangible contribution but is committed to expending substantial time in the service of the corporation.[83]

---

79. *See* V. BRUDNEY & M. CHIRLSTIEN, CORPORATE FINANCE (1975), for a more comprehensive guide to financial considerations on incorporation.
80. *See* D. HERWITZ, BUSINESS PLANNING 135 (1966).
81. Some such preliminary tax matters include the election to be a Subchapter S corporation (*see* INT. REV. CODE OF 1954, § 1371), the decision to implement a stock plan under § 1244 of the Internal Revenue Code (*id.* § 1244), and a determination as to the advisability of seeking nonrecognition under § 351 of the Internal Revenue Code in connection with certain transfers of property to a corporation in exchange for its stock or securities, and if such determination is made in the affirmative, then seeking to qualify such transfer within § 351 (*id.* § 351).
82. *See* MD. ANN. CODE, Corp. & Ass'ns Art., § 2-105(3), (4), (5) and (6) (1975).
83. For an example of such a privately-held corporation organizational pattern, *see* D. HERWITZ, BUSINESS PLANNING prob. 1, at 1 (Supp. 1976).

Frequently in such a situation, the parties making the substantial cash and asset contributions will not be involved in the day-to-day operation of the enterprise but, nevertheless, may desire to participate in control and clearly seek a return in the investment which they have in the enterprise. On the other hand, the contributor of nominal tangible consideration may be content with his or her salary and look only for long-term appreciation of his or her interest in the business as well as some portion of control. Allocating control in the corporation through common stock on the one hand, and guaranteeing a priority return on investment through preferred stock or other senior securities on the other, can accomplish the objectives of the stockholders under these circumstances. Moreover, the utilization of common stock to be issued for nominal consideration from each of the stockholders and preferred stock to be issued for the more significant contribution of cash and assets by two of the stockholders should assist in eliminating bargain compensation tax problems[84] while allowing qualification for a tax-free incorporation pursuant to Section 351 of the Internal Revenue Code.[85]

In another practice setting, certain investors may desire the right to redeem their stock prior to the holders of other classes of stock.[86] This objective may be justified when the investor simply wishes to encourage the initial growth of the enterprise by supplying it with working capital in the form of equity, but expects to recoup his investment when the enterprise is sufficiently established to obtain capital from other sources.

Another occasion when preferences may be particularly important is upon liquidation.[87] By according priorities to stockholders who have invested capital, counsel can assure, to the extent of available assets, that their investment will be returned before liquidated assets are allocated to other stockholders.

Finally, capital investors may seek preferences on declaration of dividends,[88] and may require that counsel include provisions for making such dividends cumulative. The following provision is suggested as one alternative for meeting such requests:

> (1) In the event of any voluntary or involuntary liquidation (in whole or in part), dissolution, or winding-up of

84. *See* Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).
85. INT. REV. CODE OF 1954, § 351. For a discussion of problems respecting Section 351, *see* W. PAINTER, BUSINESS PLANNING 134–50 (1975).
86. Such preference is authorized by MD. ANN. CODE, Corp. & Ass'ns Art., § 2–105(5) (1975). The Code does, however, place certain restrictions on the redemption of stock. *See id.* § 2–311.
87. Such preference is authorized by *id.* § 2–105(4).
88. Such preference is authorized by *id.* § 2–105(3)(i).

the Corporation, the holders of the Common Stock and the Preferred Stock of the Corporation shall be paid out of the assets of the Corporation available for distribution to its stockholders in the following order of priority:

(a) First, to the holders of the Preferred Stock an amount equal to all unpaid accumulated dividends, if any, thereon, without interest.

(b) Second, to the holders of the Preferred Stock an amount equal to _____ Dollars ($_____) per share and to the holders of the Common Stock an amount equal to _____ Dollars ($_____) per share; provided, however, that in the event that the assets of the Corporation available for distribution are insufficient to make the distributions with respect to each class of stock above set forth in this sub-paragraph (b), then the aggregate amount distributed hereunder shall be divided among the respective classes of stock in the following proportions:

(i) _____% to the holders of the Preferred Stock.

(ii) _____% to the holders of the Common Stock.

(c) Third, thereafter, the remaining assets of the Corporation available for distribution to its stockholders shall be distributed among and paid to the holders of Preferred Stock and Common Stock, share and share alike and without any distinction as to class, in proportion to their respective stockholdings.

A merger or consolidation of the Corporation with or into any other corporation, a share exchange in which the Corporation acquires all the issued or all the outstanding shares of stock of one or more classes of another corporation by a stockholder vote and which does not affect the corporate existence of the Corporation, or a sale, lease, exchange, or transfer of all or any part of the assets of the Corporation which shall not in fact result in the liquidation (in whole or in part) of the Corporation and the distribution of its assets to its stockholders shall not be deemed to be voluntary or involuntary liquidation (in whole or in part), dissolution or winding-up of the Corporation.

(2) The holders of the Preferred Stock shall be entitled to receive at the end of each and every fiscal year of the Corporation, but only when and as authorized by the Board of Directors of the Corporation, out of the assets of the Corporation legally available for dividends, cash dividends at the rate of _____ Dollars ($_____) per share for each fiscal year of the Corporation, without interest, before any sum or sums shall be set aside for or

> applied to the purchase or redemption of the Preferred Stock or the purchase, redemption or other acquisition for value of any other class of stock and before any dividend shall be paid or declared, or any other distribution shall be ordered or made, upon any other class of stock; provided, however, that the declaration and payment of dividends on the Preferred Stock shall be subject to and in accordance with the following: If any dividends payable on the Preferred Stock with respect to any fiscal year of the Corporation are not paid for any reason, the right of the holders of the Preferred Stock to receive payment of such dividend shall not lapse or terminate, but said unpaid dividend or dividends shall accumulate and shall be paid without interest to the holders of the Preferred Stock, when and as authorized by the Board of Directors of the Corporation, before any sum or sums shall be set aside for or applied to the purchase or redemption of the Preferred Stock or the purchase, redemption or other acquisition for value of any other class of stock and before any dividend shall be paid or declared, or any other distribution shall be ordered or made, upon any other class of stock.

To reinforce a dividend preference, consideration should be given to imposing sanctions on the non-payment of preferred dividends. The most common device used by draftsmen of preferred dividend provisions is a requirement that voting control shift from holders of common stock to holders of preferred stock for periods during which preferred dividends have not in fact been paid.

Completed articles of incorporation spell out the basic rights respecting control and financial interest in the corporation, and may thus be regarded as the constitution of the corporation. After drafting the articles, counsel must undertake preparation of the bylaws, which may be viewed practically as the legislation or internal administrative regulations governing corporate ministerial matters.

IV. BYLAWS

The bylaws, in contrast to the articles, need not be filed with the Department to be effective, but are instead adopted by the board of directors at its organizational meeting,[89] or by informal organizational action through unanimous written consent.[90] In a privately-held corporation, it is important to review bylaw

89. *Id.* § 2-109(a)(1). Subsequent bylaws must be adopted by the stockholders unless such power is reserved to the board by appropriate provision. *Id.* § 2-109(b).

90. *See id.* § 2-408(c), which authorizes informal board of director action and sets forth the procedure required to implement such action.

provisions and their implications with the organizing stockholders before they are submitted to the board for adoption.

Most bylaw provisions relate to administrative matters rather than to substantive matters affecting the operation of the enterprise.[91] Thus the process of choosing bylaw provisions is often simpler than the selection of appropriate charter provisions. For example, an annual stockholders' meeting is statutorily required,[92] and the bylaws need only specify the time when the meeting is to be held, either by setting the date,[93] or by naming a thirty-one day period during which the board of directors may set the date.[94] The annual meeting should generally be held approximately ninety days after the date beginning the fiscal year, which should be set after discussion with the corporation's accountant of possible tax consequences. Spelling out the fiscal year in the bylaws and allowing ninety days before the specified annual meeting date affords corporate management the opportunity to prepare fiscal year financial statements for review prior to the annual meeting.

Other bylaw provisions that contain statutory guidelines, and thus require minimum client input prior to drafting, should nevertheless be included to promote smooth corporate functioning.[95] Those matters include the procedure for calling special stockholder meetings,[96] the notice required for annual and special meetings,[97] and the place where such meetings are to be held.[98] Other similar provisions include a recitation of the board of directors' power to direct the management of the corporation,[99] authorization

91. There are no mandatory bylaw provisions. Nevertheless, the Code's lack of statutory guidelines on certain matters necessitates inclusion of provisions governing these matters if corporate needs so dictate. For example, if corporate directors are to have certain qualifications, they must be specified in the charter or bylaws, as the Code is silent on the subject. While the bylaws may contain any provision "not inconsistent with law or the charter of the corporation for the regulation and management of the affairs of the corporation," *id.* § 2-110, it is generally advisable to follow the statutory pattern and include virtually all provisions relating to capital stock and essential management functions in the charter, thus limiting the bylaws to administrative matters.
92. *Id.* § 2-501(a). Failure to hold an annual meeting does not, however, invalidate otherwise legal corporate actions. *Id.* § 2-501(d).
93. *Id.* § 2-501(b)(1).
94. *Id.* § 2-501(b)(2). Specification of a thirty-one day period accords greater potential for finding a time which is convenient to all stockholders of a privately-held enterprise.
95. Well-drafted corporate charters and bylaws can prove to be invaluable tools for guiding corporate management through its legal obligations, as those individuals charged with management duties may well be unaware of the administrative steps which they must undertake if their actions are to be legally valid.
96. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-502 (1975).
97. *Id.* § 2-504.
98. *Id.* § 2-503.
99. *Id.* § 2-401.

for designation of board committees,[100] and banking authorization.[101] Administrative matters relating to capital stock include procedures for initial issuance of stock certificates,[102] issuance of new certificates evidencing transfer of shares,[103] determination of registered holders,[104] and record date criteria, or in lieu thereof, standards for closing stock transfer books.[105]

In those areas, however, where bylaws could vary statutory provisions relating to corporate control, they merit far more cautious and considered draftsmanship than provisions covering the matters discussed immediately above. One such area is the scope of authority granted to officers in the bylaws.[106] A specific director-officer could be given express authority to direct a particular phase of the business. Such a grant of power, coupled with provisions requiring unanimous board action to alter that authority[107] or to remove the officer[108] could ensure that officer's continued unfettered control of the designated business operation. To illustrate, a vice president who is also one of three stockholders and directors of the corporation could negotiate the right to make all final product design decisions. A series of bylaw provisions insulating the officer from removal, and permitting alterations of such limitations only with the concurrence of all directors (including the officer-director in question) could accomplish the desired result.

The designation of the power to amend the bylaws may also significantly affect the allocation of control within the corporation. If a corporation is to have many more stockholders than directors, stockholder and board objectives may diverge in regard to certain matters. If the prospective stockholders decide to favor board interests in general, they can tip the scales of corporate control heavily in the board's favor by granting the board rather than the

100. *Id.* § 2-411. Although the board may delegate its authority, such delegation does not relieve the board or its members of any legal responsibilities. *Id.* § 2-411(c).
101. It may be preferable to authorize banking transactions through bank forms adopted in the corporate minutes rather than through bylaw provision.
102. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-210 (1975). *See also id.*, § 2-211, which specifies the form required for stock certificates.
103. *Id.* § 2-210(a).
104. *See id.* § 2-209 on contents and keeping of stock ledger.
105. *Id.* § 2-511.
106. *See id.* § 2-414, which provides that the scope of the officers' powers shall be delineated in the bylaws. It is generally advisable to take advantage of the statutory option to designate officers, such as a Chairman of the Board and Assistant Secretary and Assistant Treasurer, in addition to those mandated by the Code. *Id.* § 2-412(b). Designation of such additional officers facilitates attestation and execution of corporate documents. *See id.* § 1-301.
107. *See* notes 64-66 and accompanying text *supra*.
108. *Id.*

stockholders the right to amend the bylaws.[109] Such power would permit the board to alter notice and quorum requirements to dilute stockholder power. If the directors are given authority to amend the bylaws by increasing the size of the board,[110] and such power is unchecked by altering the directors' statutory right to fill board vacancies,[111] a majority of the board will be in a position to dilute the effectiveness of assertions of minority interests. In such circumstances the following provisions might be used to protect minority interests:

> In the event that the number of directors is increased as provided in these bylaws, the additional directors so provided for shall be elected by a majority of the shares entitled to vote for such directors at a special meeting of the stockholders to be called by the President with respect thereto, and shall hold office until the next annual meeting of stockholders and thereafter until his or their successors shall be elected.
>
> The stockholders, and only the stockholders, shall have the power and authority to amend, alter or repeal these bylaws or any provision thereof, and may from time to time make additional bylaws.

Traditionally, more significant matters respecting control and voting rights within the corporation are covered by the charter as discussed above.[112] Nevertheless, the bylaws have traditionally been utilized to state quorum requirements for board of directors and stockholder meetings. Such quorum requirements should be drafted to complement provisions respecting voting that have been included in the charter. Board of directors' meeting quorum requirements highlight a crucial control implication of the bylaws. One example of the implication of quorum requirements is discussed above.[113] Another example could involve a corporation with a four-person board of directors (who presumably are the only stockholders of the corporation). Absent a special quorum requirement and voting requirements in the charter, action could be taken by such board upon the votes of only two directors.[114] To avoid such a possibility, the quorum requirement should be tied

109. *See* MD. ANN. CODE, Corp. & Ass'ns Art., § 2-109(b) (1975), which vests the power to alter the bylaws in the stockholders, subject to charter or bylaw variation.
110. *See id.*
111. *Id.* § 2-407.
112. *See* text accompanying notes 41-78 *supra.*
113. *See* text accompanying notes 59-61 *supra.*
114. *See* note 60 *supra.*

to attendance of the entire board of directors.[115] Such a provision practically eliminates the possibility of director action by less than a majority of the board, and assures all directors in a privately-held corporation a voice in board decisions.

V. CONCLUSION

This article does not discuss other incorporation matters such as the organizational meeting of the board of directors,[116] stock issuance,[117] and buy-sell agreements.[118] Nevertheless, it provides a review of control and financial considerations affecting the drafting of articles of incorporation and bylaws, and demonstrates the breadth of information that must be communicated by counsel to a group of clients in connection with the incorporation of their enterprise. Upon having such information communicated to them, clients should comprehend that the organization of a corporation is much more than the process of preparing and filing standard documents, but rather involves accommodating their divergent interests through a wide range of planning possibilities accorded them by the Code. Any general practitioner advising a group of prospective stockholders planning a privately-held corporation must not merely rely on a given set of forms. Rather, he or she must be fully cognizant of all requirements and options set forth in the Code.

115. Clients should be advised that such a quorum requirement could make it difficult to conduct board meetings, since the absence of any board member precludes a quorum. At the same time, however, a director who purposely absents him or herself from a meeting to prevent a quorum may be estopped from objecting to the meeting being conducted without him or her. *See* Gearing v. Kelly, 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962).

116. MD. ANN. CODE, Corp. & Ass'ns Art., § 2-109 (1975).

117. *See id.* §§ 2-201 to 2-216.

118. *See* SHAPIRO & SACHS, *supra* note 5, ch. 3 (1976), and Ghinger, *Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances,* 4 U. BALT. L. REV. 211 (1975).