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Drafting a Shareholders' Agreement for a New York Close Corporation

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DRAFTING A SHAREHOLDERS' AGREEMENT FOR A NEW YORK CLOSE CORPORATION

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Can two walk together, except they be agreed? Amos 3:3.

DRAFTING a shareholders' agreement is one of the most important tasks which a lawyer for a close corporation will be called upon to perform. The ultimate success, or failure, of the close corporation plan setup will usually depend on the skill with which this task has been performed. It is, therefore, essential that the greatest care be devoted to drafting an agreement which will accord with the desires and needs of all the participants in the close corporate venture—and will be clear enough so that no litigation over interpretation of its terms will be required—after the corporation begins to function.

I. Pre- and Post-Incorporation Agreements

It is possible to have an agreement which will merely set forth the agreement of the participants to set up a corporation, the financial participation which each will have, and the general shape which the corporation to be formed will take (*e.g.*, its name, the provisions which will be set forth in the certificate of incorporation, and perhaps the by-laws). This is a "pre-incorporation agreement."

Once the corporation has been set up and the participants are then "shareholders," they may enter into an agreement obligating themselves to a certain conduct in their operation of the corporation, its employment and profit-sharing policies, and how interests in the corporation and the corporate existence itself will be terminated. Such an agreement is properly called a "shareholders' agreement," and often in the past was a separate document from the agreement to incorporate.

There is no reason why the two types of agreement cannot be combined into one, which will govern both pre- and post-incorporation relations between the close corporate participants, and this is the more modern practice. Such a combination has the obvious advantage of saving a certain amount of work for the lawyer. It has the even more important advantage of not postponing such an agreement until a time when concurrence on its terms can perhaps no longer be reached, the same time when such an agreement is most needed.

Furthermore, since, as will be seen below, many of the portions of any desired management arrangement can only be insured success if suitable

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provisions are inserted in the certificate of incorporation, such advance planning will obviate the necessity of later amendment of the certificate, even if agreement on its new terms can be secured. In drafting such an agreement, however, the pre- and post-incorporation aspects of the one agreement must be kept clearly in mind.

Too often, clients make an advance agreement for carrying out a business activity—what would legally be termed a "joint venture"—and then decide that the form for carrying the project out will be one, or sometimes more than one, corporation. The widely recognized rule is that a joint venture may not be carried out through the instrumentality of a corporation.[1] This principle is equally applicable to portions of many shareholders' agreements even though drafted expressly only for a particular corporation. The simplest way of expressing the rule with regard to both joint ventures and such portions of shareholders' agreements is to say that certain arrangements *do not survive incorporation.* It is, therefore, obviously important to differentiate in drafting the combined pre- and post-incorporation agreement between those matters which will, and those which will not, survive incorporation.

Any provision of the agreement which flies in the face of the corporation statute will ordinarily not survive. If the parties are already partners, it is best for them to discard the partnership agreement and enter into a separate shareholders' agreement moulded in terms of the corporation law as to any corporation or corporations through which they want to carry on the business, rather than to treat these corporations as mere appendages, subordinate to their basic partnership arrangement. In short, they should agree to operate corporations, not merely through corporations.

Lawyers for "real-estate syndicates" frequently disregard this advice. For example, if two partners own (or are going to build or buy) a number of apartment houses, the agreement will often provide for an equal split of profits and losses between the participants, but for separate incorporation of each property. If any stock is issued (and often none is) it will be distributed in a haphazard fashion, all in one corporation to one, all in another to the other partner. Later, in the simplest problem which can arise, one partner wants his share of the profits of an apartment in which he owns no shares, and wants his partner to share the losses on another in which he is the sole "owner." That is when the trouble starts. Such agreements fly in the face of the corporation statute and, accord-

1. Weisman v. Awnair Corp. of America, 3 N.Y.2d 444, 144 N.E.2d 415, 165 N.Y.S.2d 745 (1957), and cases cited therein; Baker & Cary, Cases on Corporations 284-85 (3d unabr. ed. 1958) [hereinafter cited as Baker & Cary].

ingly, may be said to merit the unfavorable treatment they get from the courts.

Similarly, any agreement, even though drafted for only one corporation, which attempts to allocate control and financial return in a manner different from that to which the participants will be entitled by virtue of the number of shares and creditor obligations which they own, is dangerous. Such an arrangement can be made, but ordinarily only through careful drafting of certificate of incorporation provisions, and not directly through the vehicle of a mere agreement. An advance agreement which attempts to treat a corporation as nothing more than a partnership—*i.e.*, which ignores the corporation statute—is not really a pre-incorporation agreement, but rather one which can only really be used for an unincorporated venture.

A proper pre-incorporation agreement includes an obligation on the part of the real participants to form a corporation, under a certain name (or alternate names, to take care of the possibility that the preferred name may be unavailable[2]), for certain business purposes, and with a certain financial structure, and in which the participants bind themselves to take a specified number of shares of stock at specified prices in cash or property—*i.e.*, the agreement contains a share subscription contract.

A typical post-incorporation agreement (technically, only an agreement governing post-formation matters can properly be called a "shareholders' agreement" since only after incorporation do the participants become "shareholders") attempts to regulate the behavior *inter se* of the participants in a close corporation with regard to the operation of the corporation, profit distribution, resolution of disagreements, and termination of interests in the venture, or termination of the venture itself.

As will be seen below, where the agreement attempts to combine the

2. N.Y. Bus. Corp. Law § 303 allows, among others, a person intending to form a domestic corporation to reserve a name for sixty days for the modest fee of $10. A simple letter, on the lawyer's stationery, addressed to the Secretary of State, Albany, setting forth the following is sufficient for a new domestic corporation: (a) the name and address of the applicant; (b) the name to be reserved (three should be given in the alternative, e.g., "X Inc., or if such name is not available, Y Inc., or if such name is not available, Z Inc."); (c) the basis for the application under paragraph (a) of § 303 of the N.Y. Business Corporation Law (e.g., "The applicant intends to form a domestic corporation under said name."). See N.Y. Bus. Corp. Law § 303(b) (Supp. 1966). For good cause shown, a maximum of two sixty-day extensions can be granted. N.Y. Bus. Corp. Law § 303(c).

It will ordinarily be worthwhile, accordingly, to secure the name before typing up the agreement. It should be noted that the certificate of reservation must be delivered to the Department of State when the certificate of incorporation is sent for filing, i.e., must physically accompany it. If it is lost or destroyed, an affidavit to that effect is required. See N.Y. Bus. Corp. Law § 309(b) (Supp. 1966). See also 19 N.Y.C.R.R. Parts 146-47 (1963).

two portions it will be necessary to consider the post-incorporation aspects in the pre-incorporation stage in order to mould an arrangement which will be at all adequate to meet the desires of the clients once the corporation is under way. And it will be necessary as to both to keep the requirements of the corporation statute clearly in mind.

II. Partnership Agreement Moulded to Fit the Corporation Statute

The combined pre- and post-incorporation agreement in its scope of coverage is, of course, analogous to the ordinary partnership agreement. The problems arise, however, in that, while even in jurisdictions which have adopted the Uniform Partnership Act the parties are generally free to alter its terms by agreement among themselves, corporation statutes are not ordinarily so malleable. The typical partnership agreement—ordinarily the ideal arrangement for the close corporation as well —must be moulded, rather like a woman being squeezed into a girdle, into the more rigid framework of the corporation statute, while still retaining its basic identity as a simple understanding among persons who are still essentially partners although operating in corporate form.

The problem can be illustrated by considering a difficult problem, the shareholder agreement in the case of *Nickolopoulos v. Sarantis*,[3] a New Jersey case. The agreement provided:

> This agreement witnesseth, despite any contrary provision in the certificate of incorporation or by-laws: Thomas M. Nickolopoulos is to be entitled to a fifty per cent. vote either at a stockholders' meeting or at a directors' meeting, in connection with any proposition or matter pertaining to the affairs of Goody Sweet Shop, Inc., and which may be brought up at any meeting of the stockholders or of the directors. The said Thomas M. Nickolopoulos shall have this fifty per cent. vote despite the fact that he is only the holder of twenty-five shares [25 per cent] of the capital stock.[4]

The court held the agreement void because "in violation of the corporation laws of the state."[5] It was too straightforward a partnership arrangement, which flew in the face of the normal corporate paradigm, instead of bending to fit it. The agreement may not be typical in its 50% vote for only 25% investment interest feature; it is, however, a typical reflection of the desires of close corporate participants to allocate financial and control participation in a manner different from the ordinary corporate one-vote-for-one-share, majority-controls pattern. Typical, also, is the fact that the clients regard their arrangement as a simple, sensible plan which any lawyer should find easy of accomplishment.

3. 102 N.J. Eq. 585, 141 Atl. 792 (Ct. Err. & App. 1928).
4. Id. at 586, 141 Atl. at 793.
5. Id. at 587, 141 Atl. at 793.

Unfortunately, as in the *Nickolopoulos* case, their lawyers sometimes are deluded into agreeing that a direct and straightforward approach will be sufficient. More unfortunate, however, is the fact that, although perhaps it should not be, this is one area of the law which is fraught with technicalities.

The clients' desires in the *Nickolopoulos* case, and in most other close corporate situations, could, however, be accommodated, but a goodly amount of thought on the lawyer's part is always necessary. Thus, Nickolopoulos' twenty-five shares represented one-quarter of the stock. There were three other shareholders, each apparently also owning one-quarter of the stock. The objective of the agreement could have been exactly accomplished by providing for two classes of corporate stock, a "Class A" stock, each share of which had a par value one-third as great as that of each "Class B" share—*e.g.*, if each shareholder were to contribute $3000, each "Class A" share could be $1 par value, while "Class B" could have a $3 par value, per share. Nickolopoulos could then have 3000 "Class A" shares, while the other three shareholders each had 1000 shares of "Class B" stock.[6] Each class of stock could be given the right to elect an equal number of directors to the board, and, since some "dummies" would have to be used, provisions for removal of directors without cause by the class of shareholders electing them[7] could be added to protect Nickolopoulos from the possibility that any of his directors might turn against him and vote with the directors elected by the other shareholders (or, at least, guaranteeing that they would only do it once). As to other matters, the two classes of stock would vote together—*i.e.*, not as classes.[8] The certificate of incorporation could provide for dividend rights proportional to the par values,[9] thus giving a financial return proportional to investment.

Thus, Nickolopoulos would, despite his limited financial contribution, end up with the 50% control as a shareholder and also as a director, which control he desired and the other parties were willing to allow him.

Nickolopoulos' agreement failed because his lawyer failed to consider the corporation law when he was drafting the shareholder agreement. He failed to appreciate that the simple "partnership" agreement which he drafted flew in the face of the corporation law and, accordingly, would not survive incorporation.

6. See N.Y. Bus. Corp. Law §§ 501(a), 617(b). See also N.Y. Bus. Corp. Law § 402(a)(4). Read literally, N.Y. Bus. Corp. Law § 612(a) would seem to permit giving Nickolopoulos more than one vote per share. It is not clear, however, that this was intended by the legislature, and hence, the course suggested is safer.

7. See N.Y. Bus. Corp. Law § 706(b).

8. See N.Y. Bus. Corp. Law § 617.

9. N.Y. Bus. Corp. Law § 501(a).

The corporation laws are fairly rigid. They can, however, be bent to meet the clients' needs, through careful planning. First, the attorney must determine the desired financial-power arrangement. He must then use provisions in the shareholder agreement, certificate of incorporation, by-laws, and, perhaps, other documents[10] which together will combine, or "mesh," to secure accomplishment of that desired plan.

III. Pre-Incorporation Portion

Although the corporation will be formed by an "incorporator,"[11] he will, as in the past, probably merely act for others, and have no real financial interest in the business. Ordinarily, the lawyer will perform the function, acting for his clients, the real participants.

The participants will already have decided upon a name for their corporation. The sensible lawyer will have gotten at least three alternates from them in advance, and will have submitted the three to the Department of State for alternative reservation, indicating the order of preference.[12] Once notification that the name has been reserved has been received from the Department, the agreement can expressly provide for formation of the corporation under the particular name, since there is no longer a danger of loss of the name between initial clearance and the filing of the certificate, provided, of course, that the certificate is filed before the reservation expires.[13]

There is no express requirement under the New York Business Corporation Law that anyone agree to take—*i.e.*, subscribe for—any shares in the corporation. Nor is there any minimum financial capital requirement —*i.e.*, a requirement that a certain amount be in the till—before the corporation begins business. Even apart from any danger of personal liability for conducting business in an undercapitalized corporation,[14] the

10. Examples of such other documents which might be desirable are separate employment contracts, especially for employees who will not also be shareholders and hence will not be parties to the shareholders' agreement; share restriction and repurchase agreements are also often separate documents; even the participants' wills may have to be modified to fit the agreed-upon arrangement (e.g., to protect a Subchapter S tax election—see Art. VII, section 3 of the Agreement, infra).

11. Only one incorporator is necessary. N.Y. Bus. Corp. Law § 401. There is ordinarily no need to use more, since provision is made even for the death of the sole incorporator. See N.Y. Bus. Corp. Law §§ 404(c), 615(c).

12. See note 2 supra.

13. N.Y. Bus. Corp. Law § 303 allows an initial reservation for sixty days, and a maximum of two extensions for a like period for good cause shown by affidavit prior to expiration of the reserved period. N.Y. Bus. Corp. Law § 303(b), (c).

14. See Robinson v. Chase Maintenance Corp., 20 Misc. 2d 90, 190 N.Y.S.2d 773 (Sup. Ct. 1959); Stevens, Close Corporations and the New York Business Corporation Law of

real participants will want shares in the corporation for the management control and financial interest in the business symbolized by them. The Business Corporation Law allows pre-incorporation subscriptions to be made irrevocable for three months.[15] There is no set form for a subscription under the statute, except that it be in writing and signed by the subscriber. Obviously, then, the shareholders' agreement can constitute a valid share subscription.

The allocation of the shares to be taken by each individual participant will, of course, depend on the amount of cash or property he is willing to invest in the business. It will also be based on a determination of the relative position he is to hold in the overall distribution of power in managing the corporation, and the amount of return he is to be given should the venture prove successful. Thus, the same type of planning of the complete financial structure as that outlined above as to the *Nickolopoulos* problem will be necessary.

Although such provisions may, in the case of bonds, and will, in the case of preferred stock, disqualify the corporation for Subchapter S tax treatment, where a participant is not as interested in control over the operation of the corporation as in a secure return on his investment (or, similarly, the other participants are insistent upon greater control and he is willing to accede to their demands), the use of bonds or preferred stock may be indicated.[16]

In any event, the total financial structure of the corporation necessary to meet the various financial-power demands of the participants will have to be thought out at this point. It should be noted that, although bonds or similar creditor obligations need not be referred to in the certificate of incorporation (unless voting rights are to be conferred on

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1961, 11 Buffalo L. Rev. 481, 484 (1962). But see Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966); Bartle v. Home Owners Co-op., 309 N.Y. 103, 127 N.E.2d 832 (1955). The Walkovszky and Bartle cases indicate that there is little danger of this in New York.

15. N.Y. Bus. Corp. Law § 503 governs subscriptions for shares, whether pre- or post-incorporation. To be enforceable all share subscriptions must be in writing and signed by the subscriber. N.Y. Bus. Corp. Law § 503(b). Pre-incorporation subscriptions are (unless otherwise provided therein) irrevocable for three months (except with the consent of all of the other subscribers or the corporation). N.Y. Bus. Corp. Law § 503(a). The board of directors decides when payment must be made, unless the subscription provides otherwise. N.Y. Bus. Corp. Law § 503(c).

Provision is also made for enforcement of the subscription by the corporation or a receiver, and for forfeiture and sale (if at least 50% of the subscription price has been paid) of the shares on default in payment. N.Y. Bus. Corp. Law § 503(d).

16. As to the financial structures for various power demands see Kessler, Skeleton of the Close Corporation Provisions of the New York Business Corporation Law, 2 N.Y. Continuing Legal Ed. 57, 85-87 (1965).

the bondholders), the certificate of incorporation must authorize the various classes of shares.

It should also be observed that, once formed, the corporation can enforce payment for the shares,[17] and, in addition, a receiver, trustee in bankruptcy, or judgment creditor can bring an action to enforce the liability for the benefit of the creditors and even shareholders of the corporation.[18] Presumably, even another participant, in his capacity as shareholder, can bring a derivative action to compel a delinquent subscriber to go through with his obligation.[19]

Although it is not customary to set forth the "purpose" clause in the precise language in which it will appear in the certificate of incorporation, at least some indication of the business to be conducted should be given in the agreement. Not only should this be done to avoid a possible ground for rescinding the subscription,[20] but also because, in fairness to the participants, they should not be expected to commit themselves to a venture different from that upon which they have reached an oral understanding. Where one of the participants wants to insure that the business will not branch out into a field of which he disapproves (*e.g.*, a cafeteria being expanded to sell alcoholic beverages), greater precision in the agreement and the certificate of incorporation is required.

Obviously, the certificate of incorporation will have to be drafted in the pre-incorporation period, and, of course, the by-laws should be, as well. It is equally clear that the post-incorporation aspects of the corporation, its operation and even termination, will to a very large degree be determined by the shape of these documents. The post-incorporation phase, therefore, overlaps the pre-incorporation stage.

Where, as recommended, one agreement is to be used for both pre- and post-incorporation aspects, it is manifest, then, that the desired post-incorporation *modus operandi* must be planned in this pre-incorporation stage, in order that the certificate of incorporation and by-laws will be drawn in such a fashion as to accommodate these post-incorporation needs.

17. N.Y. Bus. Corp. Law § 628(a). See also N.Y. Bus. Corp. Law § 629.

18. See Official Comment to N.Y. Bus. Corp. Law § 628.

19. Since, under N.Y. Bus. Corp. Law § 628(a), the corporation can enforce the liability, it would appear that a shareholder may bring a derivative suit where it refuses to do so, see N.Y. Bus. Corp. Law § 626(a), (c), although the Official Comment to § 628 does not expressly mention enforcement by a shareholder.

20. Baker & Cary 765: "In the past there have been three judicially implied conditions which had to have been satisfied prior to liability on a subscription, and the subscriber could resist enforcement of the agreement by claiming non-fulfillment of any one of them. These conditions precedent were (1) that the formed corporation and/or its articles would not vary substantially from what was contemplated in the subscription agreement . . . ."

IV. Post-Incorporation Portion

Combined with the pre-incorporation portion of the agreement, the post-incorporation section should provide a complete blueprint for the life of the close corporation.

In drawing this blueprint, the aspects of the setup which will be reflected in the certificate of incorporation, and those which will be placed in the by-laws, must be carefully integrated with those provisions of the shareholder agreement which will survive incorporation. All of the provisions of the three documents must not only be consistent, but they must also mesh into a unified whole which will enable the corporation to operate as much as possible as the clients desire (or, would desire, if they thought of the problems that might arise).

In producing this arrangement it is important to keep in mind the proper provinces of each of the three documents. To a certain extent this is determined by statute. Certain matters must be placed in the certificate of incorporation for validity. A mere by-law or agreement provision will not suffice. Other matters are properly the province of the by-laws (although, alternatively, they are permissible in the certificate). It is inappropriate to have them solely in the agreement, since the agreement is personal or individual—*i.e.*, a contract among people—while the by-laws (and, a fortiori, the certificate) are general or categorical, speaking in terms of capacities rather than named persons (*e.g.*, "any shareholder," rather than "John Jones"). Somehow, however, all of these must be pieced together so that the entire result applies specially and satisfactorily to the individual clients.

One may well ask why there must be three documents; why one, the agreement between the participants, will not suffice, as it does, for example, in the partnership. There is no good reason, and, accordingly, at least one state, Florida, has, somewhat ineptly, accepted the principle that a "side agreement" among all the shareholders as to how they will run their corporation will suffice.[21] Although North Carolina,[22] South Carolina,[23] and New York[24] have taken halting steps in this direction, they have not gone as far, and, unfortunately, most other states have not gone even as far as they.

Traditionally, in the corporation there has been a strict division of functions and powers among the shareholders, directors and officers, even though the same individual may exercise all three capacities—*i.e.*, wear three different hats. In New York the dichotomy has been enforced with

21. Fla. Stat. Ann. § 608.0105 (Supp. 1966).
22. See N.C. Gen. Stat. § 55-73 (1965).
23. See S.C. Code Ann. § 12-16.22 (Supp. 1966).
24. See N.Y. Bus. Corp. Law § 620(a).

a vengeance. Under New York case law, agreements among shareholders as to how they will vote *as shareholders* have generally (although not universally) been held valid.[25] Those which sought to restrict the participants in their capacity *as directors* have generally (although not universally) been held invalid.[26] With regard to officers, the principal problem was not interference with their powers, but rather the interference with directorial powers which agreements as to their appointment posed.[27]

When restrictive decisions were overruled by the legislature, the New York practice has been to require the corporation to insert a provision in the certificate of incorporation to secure the benefit of the new law.[28] Thus, the older cases are still relevant in determining which portions of the agreed-upon financial-power arrangement will be independently enforceable in a shareholder agreement, and those which, although the agreement should require their insertion there, will have to be reflected in the certificate of incorporation for validity.

Generally, then, the shareholder agreement may contain binding provisions as to how the participants will vote *for* (but not as) directors, and such other matters as are normally within the province of shareholders—*e.g.*, enactment and repeal of by-laws, amendments of the certificate of incorporation, sale of the business, merger, consolidation, and, presumably, dissolution.[29] The exception, based on case law, is that they

25. See, e.g., Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559, 561 (1918). Compare Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945), where neither by-law provisions nor the underlying shareholder agreement requiring unanimous vote of the shareholders for election of directors and all shareholder action were upheld.

26. Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Manson v. Curtis, supra note 25; McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934). See also Clark v. Dodge, supra note 25, where such an agreement was upheld.

27. The election of officers and fixing of their salaries was formerly an exclusively directorial function. See McQuade v. Stoneham, supra note 26. This situation has been corrected in New York by allowing the corporation to insert a provision in its certificate of incorporation to allow the shareholders to elect all or specified corporate officers. N.Y. Bus. Corp. Law § 715(b).

28. As to high vote and quorum provisions see Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); N.Y. Bus. Corp. Law §§ 616, 709 (following N.Y. Stock Corp. Law § 9); as to election of officers see McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); N.Y. Bus. Corp. Law § 715(b); as to agreements which "sterilize" the board of directors see Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, supra; Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918); N.Y. Bus. Corp. Law § 620(b) (Supp. 1966).

29. The shareholders (two-thirds of all outstanding shares entitled to vote thereon) may dissolve the corporation. N.Y. Bus. Corp. Law § 1001. Since, therefore, it is a shareholder subject, an agreement to vote for dissolution should be valid in a shareholder agreement. N.Y. Bus. Corp. Law § 620(a) provides that the shareholders may by an agreement

may not require the presence or vote of more than a majority of the shares for any shareholder matter (nor, of course, may they effectively include merely in the by-laws any provision which the law requires to be contained in the certificate for validity).[30]

A shareholders' agreement may also properly contain reasonable restrictions on the transfer of the signatories' shares.[31] Officially, a corporation has no particular concern in the disposition of its shares once they are issued and the full consideration is paid for them. Hence, this is a proper matter for contract among the individual shareholders. Of course, for the corporation to be bound not to recognize transfers made in violation of the agreement, it should at least become a party to the contract.

A corporation can, of course, enter into other contracts as well, including contracts of employment. Thus, although the participants may technically lack the power to commit it to do so, once it becomes a party to the employment sections of a shareholders' agreement, they are a contract between it and the employee. Hence, such provisions, too, are appropriate to the post-incorporation portion of the shareholders' agreement.

The shareholders' agreement may not by itself effectively bind the participants as to how they will vote in their capacities as directors—*i.e.*, in their ordinary management of the business of the corporation.[32] Clearly, high vote and quorum requirements as to board meetings are also proscribed.[33] For the arrangement to be effective in any of these areas, a certificate provision is required.[34] The exception is such an agreement as was upheld in *Clark v. Dodge*[35]—*i.e.*, under the older case law. In that case the agreement between the two sole shareholders (Clark, the plaintiff and owner of 25% of the stock, and Dodge, the defendant and owner of the balance)

> provided, in substance, as follows: That Dodge during his lifetime and, after his death, a trustee to be appointed by his will, would so vote his stock and so vote as a

"provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them." It may be held, however, that N.Y. Bus. Corp. Law § 1002, which requires a certificate of incorporation provision for dissolution at will or upon occurrence of a specified event, has preempted the field.

30. See Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945).

31. Tomoser v. Kamphausen, 307 N.Y. 797, 121 N.E.2d 622 (1954); Richards v. Ernst Wiener Co., 207 N.Y. 59, 100 N.E. 592 (1912); Greater N.Y. Carpet House, Inc. v. Herschmann, 258 App. Div. 649, 17 N.Y.S.2d 483 (1st Dep't 1940); Hassel v. Pohle, 214 App. Div. 654, 212 N.Y. Supp. 561 (2d Dep't 1925). See also N.Y. Bus. Corp. Law § 514.

32. See cases cited note 26 supra.

33. See Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945), in which one of the invalid by-laws required a unanimous vote of directors.

34. See note 28 supra.

35. 269 N.Y. 410, 199 N.E. 641 (1936).

director that the plaintiff (a) should continue to be a director of Bell & Company, Inc. and (b) should continue as its general manager so long as he should be "faithful, efficient and competent"; (c) should during his life receive one-fourth of the net income of the corporations either by way of salary or dividends; and (d) that no unreasonable or incommensurate salaries should be paid to other officers or agents which would so reduce the net income as materially to affect Clark's profits.[36]

Obviously, provisions (b), (c) and (d) impinged on the participants' functions as directors. The agreement was nonetheless sustained, apparently on two grounds: (1) the absence of harm or threat of harm to possible purchasers of stock, creditors, minority stockholders and the public—*i.e.*, "there is no damage suffered by or threatened to anybody";[37] and (2) the deviation from the "statutory norm" that the corporation be managed by its board of directors was insignificant—*i.e.*, the invasion of the powers of the directorate was "so slight as to be negligible,"[38] and there was "no attempt to sterilize the board."[39] Implicit in the first ground, and emphasized a number of times in the opinion, was the fact that all of the shareholders were parties to the agreement.

Section 620(b) of the Business Corporation Law permits, under certain specified conditions,[40] a provision "otherwise prohibited by law be-

36. Id. at 413-14, 199 N.E. at 642.

37. Id. at 417, 199 N.E. at 643.

38. Ibid.

39. Ibid.

40. The relevant portions of N.Y. Bus. Corp. Law § 620 (Supp. 1966) read as follows: "(b) A provision in the certificate of incorporation otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter, shall nevertheless be valid:

(1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certificate of incorporation or an amendment thereof; and

(2) If, subsequent to the adoption of such provision, shares are transferred or issued only to persons who had knowledge or notice thereof or consented in writing to such provision.

(c) A provision authorized by paragraph (b) shall be valid only so long as no shares of the corporation are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association.

. . . .

(f) The effect of any such provision authorized by paragraph (b) shall be to relieve the directors and impose upon the shareholders authorizing the same or consenting thereto the liability for managerial acts or omissions that is imposed on directors by this chapter to the extent that and so long as the discretion or powers of the board in its management of corporate affairs is controlled by any such provision.

(g) If the certificate of incorporation of any corporation contains a provision authorized cause it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter . . . ." Following the usual New York practice, however, in overruling restrictive case law decisions, such a provision is required to be set forth in the certificate of incorporation for validity. The Official Comment to section 620(b) states: "Paragraph (b) expands the ruling in Clark v. Dodge . . . ." Thus, the legislative intention appears clear that an agreement such as that in the *Dodge* case is still valid, as an agreement—*i.e.*, without a certificate provision. However, it would appear essential that the conditions in the case also be met—*i.e.*, not only that no harm be done or threatened to outsiders (it is difficult to see how even the agreements struck down in other cases could have any harmful effect on outsiders[41]), but also that the agreement be entered into by all of the shareholders (to avoid potentiality of harm to minority shareholders). Furthermore, the agreement must constitute only a slight impingement on the powers of the board, only a slight deviation from the "statutory norm." Not only does a provision that the board and officers shall be subservient to a minority shareholder[42] deviate too much, but so does a provision (even though approved by all of the shareholders) which vests management in a shareholder for nineteen years,[43] and even one (similarly agreed to by all shareholders) which requires unanimity for board and shareholder action.[44]

Accordingly, it is very difficult to say how much further an agreement can go than that in the *Dodge* case and still be valid without a certificate provision. An agreement identical to that in *Dodge* should be safe. The only safe course for an agreement that differs at all from its terms (and circumstances) is to embody it (with appropriate generic, rather than

by paragraph (b), the existence of such provision shall be noted conspicuously on the face or back of every certificate for shares issued by such corporation."

41. For example, in McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934), only a signatory to the agreement was complaining rather than a minority shareholder or creditor.

42. Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

43. Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

44. Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945). It seems clear that a certificate provision is required, since N.Y. Bus. Corp. Law §§ 616 and 709 carry over the same references to the certificate of incorporation which were interpreted under the old law, N.Y. Stock Corp. Law § 9, to render unenforceable a mere by-law provision. Model, Roland & Co. v. Industrial Acoustics Co., 16 N.Y.2d 703, 209 N.E.2d 553, 261 N.Y.S.2d 896 (1965); In the Matter of William Faehndrich, Inc., 2 N.Y.2d 468, 141 N.E.2d 597, 161 N.Y.S.2d 99 (1957).

specific, terms wherever possible) in the certificate of incorporation, or to utilize other accepted procedures—*e.g.*, a certificate provision for high quorum and vote requirements for director action—to accomplish the desired end.

The statute specifies a number of matters which are proper to the by-laws. Although perhaps enforceable in a shareholder agreement to which all of the shareholders and directors and the corporation are parties, the wisest course would seem meticulously to follow the statute in this regard, as well.

It is clear, then, that in drafting the shareholders' agreement, the draftsman will have to keep clearly in mind the distinctions between the agreement, the certificate and the by-laws, and, carefully following the law, allocate the various provisions necessary to accomplish the desired structure.[45]

For all three documents to fit together, however, it is obvious that all will have to be drafted, at least in outline, contemporaneously. The shareholder agreement should take the basic desires, as in the *Nickolopoulos* case, and sort out the means to accomplish them, determining which provisions will go where—*i.e.*, in which document. In doing this, the draftsman should keep in mind the "bulwark" principle—the use of multiple provisions to secure the same result. Obviously, if it is decided that each participant is to have an equal voice (*i.e.*, veto) in the management of the corporation, not only will a certificate provision requiring unanimity for director action be required, and, since this provision is meaningless unless the participant is guaranteed a place on the board, a certificate provision requiring shareholder unanimity for election, and removal, of directors, but also agreement provisions, not only to insert these in the certificate, but also to vote for the named participant as director are also essential. This is an example of the necessary intermeshing of documents. The use of multiple devices as bulwarks, so that, if one method fails, others may still succeed in insuring the desired consequences, goes even further. Thus, an additional guarantee to the directorship necessary to accomplish the ultimate end of equal management participation can be different classes of shares, each class entitled to elect a director, with the participant given all of the shares of one class.[46]

45. For some provisions, the statute requires a shareholder adopted by-law rather than one adopted by the directors. In these situations, initial by-laws adopted by the incorporators are sufficient. N.Y. Bus. Corp. Law § 601(a) (Supp. 1966).

46. Even the well-drafted agreement in Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936), could have been bulwarked in this fashion. Under the agreement, plaintiff Clark was, inter alia, guaranteed a directorship. The agreement was held specifically enforceable after litigation carrying the matter to the court of appeals. Had the classification device been utilized, this portion of the arrangement would have been enforceable without litigation.

To further guarantee the participant's management (and financial) position in the corporation he should also be guaranteed an office. Again a certificate provision will be necessary. One requiring directorial unanimity might suggest itself, since the board ordinarily appoints the officers. The bulwark provision would, of course, be a provision in the agreement to vote for the named participants as officers. However, such a provision binds the directors in their capacity *as directors*, and hence may be invalid as improperly restricting the board. An additional certificate provision under section 620(b) is necessary. The simpler expedient is to place a provision in the certificate (as required by the agreement) providing for election of officers by the shareholders. Then the agreement provision to elect the named persons as officers should be valid, because it only binds the participants in their *shareholder* capacities. An added bulwark is a certificate requirement for shareholder unanimity on the subject of officer election and removal. Once an officer is appointed, he cannot then be removed without his consent as a shareholder. Another bulwark to the guarantee of management participation is an employment contract, so that if for any reason the participant is removed as an officer he will still retain his status as an employee—or what is more desirable and more likely to occur, no attempt will be made to oust the participant from either position, since his co-participants will realize that at best they (*i.e.*, the corporation) will have to pay damages for any such dismissal.

Another example of bulwarking is a shareholders' agreement provision to vote for voluntary dissolution under the same conditions as those set forth in the certificate for an automatic dissolution. A provision for resolution of disputes by an arbitrator giving him the power to order one faction to buy out the other, or to dissolve the corporation, can be bolstered by a clause in the agreement whereby the parties expressly agree to abide by the arbitrator's decision.

Share transfer restrictions should be embodied in the by-laws and, so far as possible, in the certificate of incorporation. Although, of course, these constitute contracts with all the shareholders, as they become such, a shareholder agreement is a contract among the *individual* shareholders by name—a voluntary commitment. If there is any question about the validity of any provision, the addition of such a voluntary agreement makes enforcement of the arrangement more justifiable.

The experienced practitioner will undoubtedly think of many more ways in which every part of the agreed-upon setup can be made airtight by the use of more than one device, so that, if the first fails, the second will accomplish the desired result. The important point, however, is that this search for multiple bulwarks should be made as to each important portion of the agreed-upon arrangement, and the interrelationship of the three corporate documents which will accomplish this must always be kept in mind.

It is also obvious from the above that in the drafting of a complete agreement there can be no rigid separation between pre- and post-incorporation portions, since the post-incorporation management will to a very considerable degree be determined by the certificate and by-law provisions determined upon in the pre-incorporation stage.

V. Checklist

It is now possible to sketch an outline of the contents of a shareholders' agreement for a close corporation. From the above discussion, it is clear that the agreement will fall into three main segments: (1) Organization, (2) Operation, and (3) Termination. It is also clear that there will be overlapping among the three, at least in the sense that all must fit together into an integrated whole, which will be a complete blueprint for the desired intra-corporate arrangement. Obviously, the list below is merely illustrative:

(1) Names and addresses of parties, and date of agreement.

(2) Whereas clauses—Tell the story (justifying the agreement) and show consideration for the contract (In consideration of their mutual promises, and sacrifices—*e.g.*, old jobs given up, etc.—the shareholders agree:).

Organization

(3) To form corporation—Specify name, state of incorporation, purpose, and capitalization.

(4) Subscriptions for shares, mode of payment, and time. (Also, perhaps, loans.)

Operation

(5) Shareholder voting agreement, including voting for directors, shareholder vote and quorum requirements, and provisions for certificate of incorporation necessary. (Perhaps, irrevocable proxy provisions.)[47]

(6) Employment of the participants as officers *and* in non-statutory positions (*e.g.*, "general managers," "plant managers"). Salaries fixed. Duties fixed (Employee agrees to use best efforts (full time or whatever), and not to compete). No change in salary (or a proportional increase)[48] or duties without his consent. Election to employee to renew. Provision for certificate of incorporation as to election of officers by shareholders. (Otherwise, officer appointment, salary, etc., provisions become part of a director agreement.)

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47. See N.Y. Bus. Corp. Law § 609(f)(5).

48. O'Neal & Derwin, Expulsion or Oppression of Business Associates—"Squeeze-Outs" in Small Enterprises § 7.05 (1961).

(7) Director agreement, including quorum and vote requirements, and provisions for certificate of incorporation. Note that, as discussed above, under section 620(b) of the New York Business Corporation Law, "director sterilizing" provisions must be in the certificate of incorporation.

(8) Dividend provisions. *E.g.*, require when surplus equals a certain amount, or restrict to protect salaries.[49] Note these affect the directors' powers.[50]

(9) Other veto provisions—*e.g.*, requirement that cheques be signed by one participant from each faction, limits on authority of officers. Provisions for by-laws and/or certificate of incorporation.

(10) Tax-election provisions.[51]

(11) Arbitration provisions. (May include whether officer or director should be removed.)[52]

Termination

(12) Restrictions on transfer of shares, *e.g.*, first offer to corporation and/or other shareholders, contract to repurchase on death, etc., funding through insurance. Buy-out to resolve dispute.

(13) Dissolution provisions. Note that, under section 1002 of the New York Business Corporation Law, dissolution at will or on occurrence of a specified event requires a certificate of incorporation provision.[53]

Miscellaneous

(14) Any other provisions desired and an agreement to place suitable provisions in the certificate of incorporation and/or by-laws, with exact language to be inserted.

(15) Term of agreement and renewability.

(16) "Saving clause," in case any provision held invalid.

(17) Corporation to become a party.

(18) Agreement not to vote for changes in certificate or by-laws.

(19) Consent to specific performance of agreement.[54] (Even a provision for liquidated damages does not preclude equitable relief.)[55]

(20) Signatures.

49. Id. at 173.

50. However, Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936), upheld a unanimous agreement limiting dividends.

51. E.g., Int. Rev. Code of 1954, §§ 1371-77.

52. N.Y. Bus. Corp. Law §§ 706, 716; Official Comment to N.Y. Bus. Corp. Law § 706. See also N.Y. C.P.L.R. §§ 7501-02.

53. See also Henn, Corporations § 267, at 418 n.11 (1961).

54. O'Neal & Derwin, op. cit. supra note 48, at 173.

55. Wirth & Hamid Fair Booking, Inc. v. Wirth, 265 N.Y. 214, 192 N.E. 297 (1934), and cases cited therein.

The order of the provisions can, in most instances, be varied, of course. An illustrative agreement, incorporating many of the above provisions, follows. Modifications will, of course, be necessary to meet the needs of particular clients and situations, and, as the cases discussed above unfortunately show, no absolute guarantee can be given that an unsympathetic court will not deny enforcement to some of its provisions.

SHAREHOLDERS' AGREEMENT

This agreement made this . . . day of ...., 19.., between ....,[1] residing at ...., ..., ..., ...,[2] residing at ...., ..., ..., ..., residing at ...., ..., ..., ..., residing at ...., ..., ..., ..., hereinafter sometimes referred to as the "shareholders."[3]

Witnesseth:

Whereas, the parties hereto have agreed to form a corporation under the terms and conditions hereinafter set forth,[4] and

Whereas, ... is the principal promoter of the enterprise and has valuable ideas for the organization of the business,[5] and further agrees to invest $............ in the shares[6] of the corporation, in consideration of the mutual obligations of the other shareholders undertaken herein, and

Whereas, ... agrees to invest $............ in the shares

1. The names here should, of course, be exactly as the typed names and signatures at the end of the agreement. Although not as apt to cause problems here, the author recalls, as a novice at the Bar, having to draw a corrective deed where the executor was named "Charles A. Smith" in the will and in the original executor's deed was described as "Charles Allen Smith." If a party is always known by a nickname—e.g., "Gus" even though his name is really "Cornelius"—it is wise to make reference to the pseudonym as well as the legal name—e.g., "Cornelius A. Smith, also known as Gus Smith."

2. Full addresses will help for identification, notification and billing purposes.

3. The corporation, although not yet in existence if the agreement is entered into, as suggested, prior to filing the certificate of incorporation, could here be named as a party.

4. It is wise to "tell the story," showing who the parties are, why they have decided to form the corporation, and their purpose in entering into the agreement. This will not only help to supply consideration, which every contract including a shareholders' agreement must show, but also will help to identify the parties and give a background valuable to any court which may have to construe the agreement. An indirect, but important, effect of this may be to predispose the court to enforcing the agreement against a party who has "changed his mind," and now seeks to "weasel out" of the bargain he has made on some technicality. Detailing of the business "know-how" which the participants will bring to the new venture may also be especially important in justifying enforcement of the non-competition covenants in the employment contract portions of the agreement. The various "Whereas" clauses which follow are designed to cover (or be readily modifiable to cover) situations likely to be encountered by the average practitioner.

5. This paragraph can be used for the "idea man." If he brings patents or copyrights to the business, reference should, of course, be made to these.

6. If the corporation is to issue preferred stock, any of which is to be taken by a party, a suitable amendment should, of course, be made. Since preferred stock is of dubious value to most close corporations, and automatically disqualifies the corporation for Subchapter S tax treatment, Treas. Reg. § 1.1371-1(g) (1963), the agreement ordinarily presupposes only the issuance of common stock.

of the corporation, and to lend to said corporation the additional sum of $..........., both in consideration of the mutual promises herein contained,[7] and

Whereas, ..., an executive of the .... Corporation, a leading manufacturer of ...., agrees to give up said executive position with said corporation and participate in the corporation, contributing his valuable knowledge and experience to said corporation, and in addition, agrees to invest $........... in the shares of the corporation, all in consideration of the mutual promises of the parties herein contained, and

Whereas, ..., an experienced sales manager, presently employed by the .... Corporation, agrees to enter the employ of the corporation, and also to invest $........... in the shares of the corporation, all in consideration of the mutual promises of the parties herein contained, and

Whereas, ... is the owner of certain [real] [personal] property as set forth in Appendix A, incorporated herein and made a part hereof, and agrees to contribute said property in exchange for .... shares of this corporation, in consideration of the mutual promises of the parties herein contained,[8] and

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7. This paragraph can be used for the "money man." Of course, if he also has "know-how" to contribute, reference to that should also be made. There is a danger that "loans" will be considered a contribution to capital—i.e., stock—not only should the corporation become insolvent, see, e.g., Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958), but, perhaps even more importantly, for tax purposes. This is likely if the corporation is thinly capitalized (i.e., has a high ratio of "debt" to stock), and the participants' "loans" to the corporation are proportional to their stock interest. See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). Subordination to the rights of other creditors may be, and absence of a maturity date is likely to be, fatal, even in the absence of other defects. See Jordan Co. v. Allen, 85 F. Supp. 437 (M.D. Ga. 1949), and cases cited therein. Avoidance of these pitfalls will not, however, guarantee success in the battle for debt treatment, since each case must turn on its own facts. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). As to factors considered and their significance see 3 CCH 1967 Stand. Fed. Tax Rep. ¶ 2377.227; 3 P-H 1967 Fed. Tax Serv. ¶ 13096. If the security "smells" like stock, it is in danger of being so treated. This means that "interest" payments will not be deductible to the corporation, and repayment of the loan may under certain circumstances constitute taxable income to the "lender." Accordingly, wherever possible, outside credit financing should be obtained if additional funds are needed.

8. This paragraph is for the participant whose contribution to the enterprise will be property. A representation to the effect that such property is free of liens, encumbrances, and security interests (or their amount) may be added.

Such exchanges of property for shares of stock may pose a "watered stock" problem. Under the New York Business Corporation Law if a shareholder is, for example, issued $100 in par value of shares for property worth only $25, he may be compelled to pay the difference. See N.Y. Bus. Corp. Law §§ 504(c), 628; Official Comment to N.Y. Bus. Corp. Law § 628. Some protection, of course, is given to the shareholder by the provision of N.Y.

Whereas, the operation of the corporation in accordance with this agreement will be in the best interests of the corporation and all of its shareholders and creditors,[9]

Now, therefore, in consideration of the foregoing, the payment of the sum of one dollar by each of the parties hereto to each of the other parties hereto, other good and valuable consideration receipt of all of which is hereby acknowledged, and the mutual covenants and promises herein contained, it is mutually agreed among the parties hereto in behalf of themselves and the corporation to be formed hereunder as follows:[10]

I. *Organization*

(1) To form a corporation under the New York Business Corporation Law (to conduct the following business) (to conduct the business set forth in the annexed certificate of incorporation, marked Exhibit A).[11]

Bus. Corp. Law § 504(a) that, in the absence of fraud, the judgment of the board as to the value of the consideration received for the shares will be conclusive. In flagrant cases this will undoubtedly not immunize the transaction. See Lake Superior Iron Co. v. Drexel, 90 N.Y. 87 (1882); Douglass v. Ireland, 73 N.Y. 100, 104 (1878); Boynton v. Andrews, 63 N.Y. 93, 96 (1875).

No-par stock, although invented to avoid such problems, may not guarantee against such watered stock liability. See Israels, Problems of Par and No-Par Shares: A Reappraisal, 47 Colum. L. Rev. 1279 (1947).

Probably the safest alternative, since the shareholder can only be compelled to make up the difference between the consideration he gave and par is to utilize low-par stock where any stock will be issued in exchange for property. Thus, for example, if two businessmen agree to form a corporation, one contributing property which may (or may not) be worth $1000, and the other contributing $1000 in cash, and agree to an equal split of ownership, the corporation might authorize 1000 shares of $1 par stock, issuing 500 to each, in exchange for his contribution. (There is, of course, nothing improper about issuing stock for more than par, the excess, if any, appearing as "capital surplus" on the balance sheet. See N.Y. Bus. Corp. Law §§ 506(a), 102(13), (2).)

9. One of the grounds upon which the agreement in Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936), was upheld was that no harm was done to shareholders, creditors or the public.

10. Formal consideration should, of course, also be shown.

11. The purposes for which the corporation will be formed should be set forth here, at least in skeleton form. In many places in the agreement, reference is made to provisions which are to be inserted in the certificate of incorporation, since many provisions of the agreement will otherwise not be legally enforceable. See Fromkin v. Merrall Realty, Inc., 30 Misc. 2d 288, 215 N.Y.S.2d 525 (Sup. Ct. 1961), aff'd mem., 15 App. Div. 2d 919, 225 N.Y.S.2d 632 (2d Dep't 1962). Obviously, there should be no conflict between the agreement and the certificate of incorporation. There are two methods of insuring the necessary congruence: (1) set forth the provisions as they will appear in the certificate, in ipsis verbis, in the agreement; or (2) prepare the certificate first (or use an appropriate one from the files) and incorporate it by reference into the agreement. Israels prefers the latter method. Israels, Corporate Practice 367 (1963). It is, of course, simpler where the lawyer's files already contain a satisfactory certificate. Preferably, the certificate should be com-

The aggregate number of shares which the corporation shall have authority to issue shall be .... shares (of $............ par value each) (without par value).[12]

(2) Each of the individual parties hereto hereby subscribes[13] for the number of shares indicated opposite his name, and agrees to purchase same, and pay therefor $............ per share in cash, as soon as the certificate of incorporation of the corporation is filed by the New York Department of State:

.... (name)	.... (number of shares)
.... (name)	.... (number of shares)
.... (name)	.... (number of shares)
.... (name)	.... (number of shares)

Such subscriptions shall be deemed accepted by the corporation upon the filing of its certificate of incorporation by the Department of State.

[(2)(a) In addition, ... of said shares of the corporation shall be issued to .... in exchange for the conveyance by him of .... to the corporation. Such conveyance, and the issuance of said shares therefor, shall be made as soon as possible after the filing of the certificate of incorporation by the New York Department of State. All of the other individual parties hereto have examined said property, and, in good faith, unanimously agree that the value of said property is at least equal to (the par value of the shares agreed to be issued hereunder) ($............).[14]]

pletely filled in, in exactly the form it will be submitted to the Department of State. See also Article X of this agreement.

12. This language will be used in the certificate. See N.Y. Bus. Corp. Law § 402(a)(4). If a class of preferred stock is to be authorized, or more than one class of common, the number of shares of each class and the par value of the shares of each class having a par value (and a statement as to which shares, if any, are to be without par value), a designation of each class, and a statement of the relative rights, preferences and limitations of the shares of each class should be inserted. See N.Y. Bus. Corp. Law §§ 402(a)(4), (5), 501(b) (Supp. 1966). In short, the capitalization of the corporation should be described exactly as required for the certificate of incorporation. It is wise to repeat the language here, even where a copy of the certificate of incorporation to be filed is annexed to the agreement to make clear the share subscription obligation of the next paragraph.

13. This paragraph should constitute a binding share subscription, irrevocable (except with the consent of all other subscribers or the corporation) for three months from the date of the agreement. N.Y. Bus. Corp. Law § 503. See also note 54 infra. The stock must not be issued prior to adoption of the plan if it is to qualify under Int. Rev. Code of 1954, § 1244. See Treas. Reg. § 1.1244(c)-1(c)(3) (1965).

14. The dollar amount can be used if the shares to be issued are no-par. It might be

[(2)(b) .... agrees to lend to the corporation, and the corporation shall borrow from the said ...., the sum of $............, the principal of said loan to be repaid on ...., ..., 19.. . Said loan shall bear simple interest at the rate of ....% per annum. Interest payments shall be made annually [or semi-annually, quarterly or monthly].[15] The corporation shall make and execute, in evidence of said indebtedness, its promissory note containing the foregoing provisions together with a mortgage and security agreement to secure the payment of said note, covering the following property: ....]

(3) The name of the corporation shall be ....

(4) The certificate of incorporation of the corporation shall be forwarded to the New York Department of State for filing as soon after the execution of this agreement as possible.[16]

II. *Directors*

(1) The corporation shall have .... directors.[17]

(2) The parties shall so vote their shares that the following named

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helpful in order to avoid "watered stock" problems to fix the consideration as the property rather than any dollar equivalent. See, e.g., G. Loewus & Co. v. Highland Queen Packing Co., 125 N.J. Eq. 534, 6 A.2d 545 (Ch. 1939). However, since a dollar valuation will ultimately have to be put on the property for bookkeeping (and tax) purposes, anyway, it might be just as well to pick a conservative dollar figure. This should not preclude issuance of the same number of shares to the property-contributor as those issued to a contributor of cash in a greater amount than that fixed as the value of the property, should that be desired, since, apparently, no-par stock may be issued at different prices to different shareholders, at least where they so agree. See Milberg v. Baum, 25 N.Y.S.2d 451 (Sup. Ct. 1941). Reference should be made in the third blank to Appendix A. See text at note 8 supra.

15. This is for the participant who will lend money to the corporation. If there are to be periodic payments, a provision might be added here for acceleration of the obligation upon default in any payment. E.g., "upon default in the payment of any installment when due the entire unpaid balance of principal shall immediately become due and payable."

16. Corporate existence begins upon such filing. N.Y. Bus. Corp. Law § 403. Once the decision to incorporate has been made it should be "followed through" by prompt filing to avoid possible individual liability of the participants through the necessity for individual commitment to avoid possible loss of a necessary asset for the business (e.g., the store site) through the insistence of the seller for an immediate contract.

17. The number of directors will be fixed in the by-laws. N.Y. Bus. Corp. Law § 702(a) (Supp. 1966). The statute also allows the number to be fixed "by action of the shareholders or of the board under the specific provisions of a by-law adopted by the shareholders." It seems better for the close corporation to have a fixed number. The number presumably can also be fixed in the certificate of incorporation if the number is to be three or more. (Proper by-law provisions are proper certificate provisions according to N.Y. Bus. Corp. Law § 402(b), although the Department of State may require convincing.) One-man corporations need only have one director, while two-man corporations may have merely two if they choose. N.Y. Bus. Corp. Law § 702(a). However, it is impossible to irrevocably fix the number of directors at less than three, since, if the number of shareholders (beneficial or of record) increases from one to two, the number of directors must increase, and, if from

persons shall be and shall remain directors of the corporation during the entire term of this agreement, except as otherwise in this agreement provided:[18] ...., ..., ...

two to more, the number of directors must become at least three. Hence, a by-law provision purporting to freeze the number at one or two is bound, at best, to be unenforceable, and will probably render the certificate of incorporation containing such a limitation unacceptable.

The number of directors can, however, be limited to the agreed number by limiting the number of shareholders. This, of course, is a function of share transfer restrictions. See Article V.

The reason for a limitation on the number of directors is, of course, to prevent a "packing" of the board by the majority shareholders to the disadvantage of the minority. See, e.g., Ripley v. Storer, 1 Misc. 2d 281, 139 N.Y.S.2d 786 (Sup. Ct.), aff'd mem., 286 App. Div. 844, 142 N.Y.S.2d 269 (1st Dep't 1955), modified, 309 N.Y. 506, 132 N.E.2d 87 (1956).

It is advisable to prescribe additional qualifications for directors—e.g., that they be shareholders. If a shareholder is, through inaction under a first-option provision, see Article V, allowed to transfer his shares to an outsider, obviously the former shareholder with no further financial interest in the corporation should be replaced by his transferee on the board. The Business Corporation Law allows the certificate or by-laws to prescribe such additional qualifications. N.Y. Bus. Corp. Law § 701 (Supp. 1966). See also note 42 infra.

It is, of course, desirable to forbid the participants from engaging in competing business activities. This may be done through the vehicle of employment contracts. See Article IV(3), (5). Where not all participants will be full-time employees, protection against disloyalty should be attempted through limitations on their activities in their directorial and/or officer capacities. Again such a limitation would seem possible under N.Y. Bus. Corp. Law § 701 (Supp. 1966) (as to directors) and § 715(g) (as to officers) in the by-laws or certificate. Of course, a separate article in the agreement could be used to require the parties to refrain from such competition. See note 56 infra.

Certain other structural provisions to make the agreement airtight should also be included in the certificate and by-laws. These include provisions for filling board vacancies, the election and removal of directors, and their powers including limitations thereon.

Unless a certificate containing such provisions is to be made a part of the agreement, see Article X, they should be set forth here, with an appropriate introduction—e.g., "the certificate of incorporation [and by-laws] shall contain the following provisions: . . . ."

For possible provisions see Kessler, Certificate of Incorporation for a New York Close Corporation: A Form, 33 Fordham L. Rev. 541, 561-64 (1965).

18. N.Y. Bus. Corp. Law § 620(a) provides: "An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them."

Even under the old law, the right of shareholders to agree to elect named persons as directors was recognized. See McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559, 561 (1918). It has been unambiguously reasserted in the New York Business Corporation Law.

It is to be noted that this agreement provision meshes very satisfactorily with a certificate of incorporation provision requiring unanimity for election and removal of directors. The agreement guarantees the election of the named participants (provided, of course, that their combined voting power is sufficient), and, even apart from the agreement (which itself should be specifically enforceable, see Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936)), such high vote provisions can guarantee them against removal, if not abso-

III. *Officers*

(1) [(a)] The corporation shall have the following four [or three, or two] officers: president, vice-president, treasurer and secretary.[19]

[(b)] A suitable provision providing for the election and removal of such officers only by the shareholders, and not by the directors, will be inserted in the certificate of incorporation.[20] A provision requiring con-

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lutely, see N.Y. Bus. Corp. Law § 706(d), at least through ability to veto the election of any replacement. Such a guarantee of representation on the board—i.e., a voice in management—is ordinarily essential to all the participants in a close corporation.

For real disloyalty—i.e., an attempt to sabotage the corporation, as opposed to mere stubbornness—the certificate or by-laws, or both, should provide for an automatic dismissal and offer of the disloyal participants' shares to the co-participants.

If obstructionism becomes chronic, dissolution, either under a certificate provision, N.Y. Bus. Corp. Law § 1002, by agreement to vote for dissolution as directed by an arbitrator or on failure to buy-out, see Article VI of this agreement, or by virtue of the petition in case of deadlock provisions of the statute, N.Y. Bus. Corp. Law § 1104, should be sufficient to handle the problem.

Selective use of the veto (high vote requirements) should prevent obstructionism from causing a deadlock, and hence obviate the necessity for even such remedies.

Therefore, although there are dangers in freezing the participants in management positions, the potential harm from not adopting such an arrangement, which may include deprivation of all income from the venture (through loss of employment and salary, diversion of profits away from dividends into "salaries" for those represented on the board, etc.) far outweigh these dangers.

The use of a combination of methods, appropriate agreement, certificate and by-law provisions, all integrated in such a fashion as to provide multiple guarantees against any loopholes to the agreed upon setup is, of course, the desideratum in any close corporation arrangement. As with this guarantee of a place on the board, such multiple insurance must, if possible, be arranged for all of the fundamentals of the close corporation structure.

19. If only three persons are involved, each of whom is to be given an office, the offices should be president, treasurer and secretary. The designation vice-president may be combined with either of the latter two, but, since the vice-president will normally preside at corporate meetings in the absence of the president, and the secretary will take the minutes, it is more practical to combine vice-president and treasurer.

If the corporation is a two-man corporation, the offices should be "president-treasurer" and "secretary." The same is true, incidentally, even if the corporation is to have only one shareholder, see N.Y. Bus. Corp. Law § 715(e), although in such an event no agreement will be necessary.

By-law provisions authorizing and defining the powers of the offices are important. See N.Y. Bus. Corp. Law § 715(g).

20. McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934), decided under the old law, held invalid an agreement by a majority, but less than all, of the shareholders, under which the parties agreed to keep certain named persons as officers of the corporation at fixed salaries, on the ground that such an agreement constituted an illegal restriction on the powers of the board of directors. Under N.Y. Bus. Corp. Law § 715(b), which had no counterpart in the prior law, the certificate of incorporation may provide that all or specified officers shall be elected by the shareholders instead of the board. If such a provision is inserted in the certificate, the election and removal of officers should become a share-

sent of all the shareholders for the election and removal of all such officers shall also be included in the certificate of incorporation.[21]

(2) The parties shall so vote their shares that the following named persons shall be elected to the offices following their names, and shall remain as such, during the entire term of this agreement, except as otherwise in this agreement provided, at the annual salaries respectively set forth:

....	....	$..................
(name)	(office)	(annual salary)
....	....	$..................
(name)	(office)	(annual salary)
....	....	$..................
(name)	(office)	(annual salary)
....	....	$..................
(name)	(office)	(annual salary)

(3) Except as otherwise in this agreement provided, or required by law, no officer shall be removed, with or without cause, for any reason whatsoever, during the term of this agreement.[22]

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holder function, and hence no longer subject to objection, since an agreement among shareholders as to how they will vote as shareholders is valid under N.Y. Bus. Corp. Law § 620(a), as it was under the old law. See, e.g., Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918). Whence the provision in the agreement that an appropriate provision allowing such shareholder selection be placed in the certificate of incorporation.

It should be noted that a shareholder agreement entered into by all of the shareholders to keep named parties as officers may well be valid, even though no such certificate provision is utilized. See Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); In the Matter of Estate of Block, 186 Misc. 945, 60 N.Y.S.2d 639 (Surr. Ct. 1946); Martocci v. Martocci, 2 Misc. 2d 330, 42 N.Y.S.2d 222 (Sup. Ct.), aff'd mem., 266 App. Div. 840, 43 N.Y.S.2d 516 (1st Dep't), motion for leave to appeal denied, 266 App. Div. 917, 43 N.Y.S.2d 517 (1st Dep't 1943); Harris v. Magrill, 131 Misc. 380, 226 N.Y. Supp. 621 (Sup. Ct. 1928). Since, if all of the participants in the business are parties to the agreement, there is no practical problem in inserting a N.Y. Bus. Corp. Law § 715(b) provision in the certificate, it would seem unwise to rely on these cases when it is so easy to make the arrangement airtight by requiring the appropriate certificate provision. If a certificate of incorporation containing the provision is made a part of the agreement, this paragraph can be omitted, and the designation "(a)" omitted from the preceding paragraph.

21. If not all of the participants are parties to the agreement, it is unwise to require unanimity for election of officers, although, of course, unanimity for removal is probably wise. In the absence of such participation by all parties to the business in the agreement, however, it is doubtful that the necessary certificate provision authorizing shareholder election of officers will be adopted, at least if the non-signers are well advised.

22. It has been held that an agreement to keep persons as officers, even though unfaithful, is contrary to public policy. Fells v. Katz, 256 N.Y. 67, 175 N.E. 516 (1931). At best, an agreement which omits such a condition will probably be construed to contain it. See In the Matter of Estate of Block, 186 Misc. 945, 60 N.Y.S.2d 639 (Surr. Ct. 1946). To prevent any possibility of invalidity on this ground, or of "conflict" with the statutory norm of N.Y. Bus. Corp. Law § 716(c), which allows an action for removal to be brought by the attorney-

(4) Except as otherwise required by law, no officer shall be suspended, except upon a unanimous finding that he is no longer faithful, efficient and competent to perform his duties.[23]

(5) No suspension of any officer shall deprive him of any salary, wages or other compensation to which he would otherwise be entitled under this agreement, or any other contract entered into pursuant thereto.[24]

IV. *Employees*

(1) The following named persons will be employed in the capacities designated after their names, at the annual salaries respectively set forth, with the duties hereinafter provided for each position, and each expressly accepts said employment:[25]

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general or the holders of ten percent of the outstanding shares, the language forbidding removal has been qualified by making it subject to law. See also note 42 infra.

23. Shareholder-elected officers may nonetheless be suspended by the board for cause. N.Y. Bus. Corp. Law § 716(a). This provision is designed to make suspension as difficult as possible. The condition is taken from the agreement in Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). See also note 22 supra. The language as to unanimity has been left deliberately vague. Since directorial unanimity will be required, a certificate provision will probably be necessary for effective implementation. See In the Matter of William Faehndrich, Inc., 2 N.Y.2d 468, 141 N.E.2d 597, 161 N.Y.S.2d 99 (1957).

24. N.Y. Bus. Corp. Law § 716(b) provides that "the removal of an officer without cause shall be without prejudice to his contract rights, if any." The statute is silent on rights on suspension. However, if contract rights can survive even after removal, it can be argued that a mere suspension should not affect them.

It should be observed that the legislature apparently does not intend that an officer's contract rights should survive a removal "for cause," at least not where actual cause for such removal exists. This is made clear by the 1962 amendment of the above section, N.Y. Sess. Laws 1962, ch. 834, § 53, which substituted the words "without cause" for the previous "however effected." The fact that officer status and removal are subject to more specific statutory regulation, and hence that any agreement with regard to them is subject to greater probability of invalidity, argues in favor of additionally conferring non-officer employee status on the principal participants as an additional guarantee of a proper financial participation in the success of the venture.

25. Titles like "general manager" (caveat: this term may connote too great implied authority), "sales manager," "plant manager," "store manager," "general superintendent," "plant supervisor," "manager of the .... department" or any similar name that the inventiveness of counsel suggests can be used to characterize the participants. In this way they can be guaranteed employment, and hence continued financial participation in the corporation, without the limitations imposed on hiring them as officers and despite any termination of their officer status.

The duties should be described in as detailed a fashion as possible, including the place where they will be performed. As long as the participant-employee is represented on the board and unanimity is required as to such matters, there is little danger. Otherwise, a participant-employee may find his duties changed to those of custodian, or his sales area changed to Vietnam, as a means of coercing him into getting out of the business.

Since these contracts are not subject to the same limitations as those imposed upon

..............,	.............,	............,	$..................
(name)	(title)	(duties)	(annual salary)
..............,	.............,	............,	$..................
(name)	(title)	(duties)	(annual salary)
..............,	.............,	............,	$..................
(name)	(title)	(duties)	(annual salary)

(2) There shall be no change in any of the aforesaid salaries, nor in any of the duties of said employees, during the term of said employment.

(3) Each of the aforesaid employees shall, within a reasonable time after the commencement of business by the corporation, commence to and shall thereafter devote all of his time and attention, and best efforts, to the business of the corporation, and shall not thereafter, during the term of employment, either directly or indirectly, engage in any other business.[26]

(4) Each of said employments shall continue for a period of ...... years from the date of incorporation of the corporation formed hereunder, and shall each severally be renewable, at the sole option of the respective employees, for successive periods of ...... years each, notice of the exercise of said option to be given in writing by the employee so renewing, to the corporation at least ...... months prior to the expiration of the original contract of employment, and each respective renewal thereof.[27]

(5) Each employee who is a party to this agreement further expressly agrees that for a period of ...... years following the termination of his employment by this corporation (however the same may occur) he will not, directly or indirectly, for himself or as agent or employee of, or on behalf of, or in conjunction with, any person, firm, association or corporation, engage in (the business of selling goods or rendering services in competition with those sold or rendered by the corporation)[28] (or be

contracts "hiring" the participants as officers, see notes 22-24 supra, it may be wise to provide the bulk of their remuneration as employees, rather than in their officer capacity.

26. Ordinarily, each participant will be expected to "pull his oar." If the money man is to be given an employment contract, which he may demand for additional protection of his investment, obviously suitable modifications in terms of the amount of time and attention devoted will be necessary.

27. Employment contracts must be "reasonable." Although even a lifetime contract is probably valid if approved by the board, see Heaman v. E. N. Rowell Co., 261 N.Y. 229, 185 N.E. 83 (1933), validity can be assured by choice of a shorter period of time, see, e.g., Staklinski v. Pyramid Elec. Co., 6 App. Div. 2d 565, 180 N.Y.S.2d 20 (1st Dep't 1958), aff'd, 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959), in which the contract was for eleven years, and its validity on this ground was unquestioned, and the advantage of a long term contract secured by leaving renewability to the participant-employee. See also note 42 infra.

28. An agreement not to compete is, of course, essential to prevent a dissatisfied

connected in any manner with any business of the type and character of business engaged in by the company at the time of such termination)[29] within a radius of ....

(6) All parties hereto recognize that the respective services to be rendered by each of the employees under this agreement are special, unique and of extraordinary character.[30]

V. *Share Transfers*

(1) No shareholder [who is a party to this agreement] shall during his lifetime sell, mortgage, hypothecate, transfer, pledge, create a security interest in or lien on, encumber, give, place in trust (voting or other), or otherwise dispose of all or any portion of his shares in the corporation now owned or hereafter acquired, except that if a shareholder [who is a party to this agreement] should desire to so dispose of any of his shares in the corporation during his lifetime, he shall first offer to sell all of his shares to the corporation at the price hereafter provided. Any shares not purchased by the corporation within ...... days after receipt of such offer in writing shall be offered at the same price to the other shareholders [who are parties to this agreement], each of whom shall have the right to purchase such portion of the remaining shares offered for sale as the number of shares owned by him at such date shall bear to the total number of shares owned by all the other shareholders [parties to this agreement] excluding the selling shareholder, provided, however, that if any shareholder does not purchase his full proportionate share of the shares, the balance thereof may be purchased by the other shareholders [parties to this agreement] equally. If his shares are not purchased by the remaining shareholders [who are parties to this agreement] within ...... days of the receipt of the offer to them, the shareholder desiring to sell his shares may sell them to any other person but shall not sell them without giving the corporation and the remaining shareholders the right to purchase

participant from setting up a competing business to ruin his former "partners." Such an agreement must be reasonable as to time and area. This provision is modified from Avallone v. Elizabeth Arden Sales Corp., 344 Mass. 556, 183 N.E.2d 496 (1962), in which it was enforced against the former employee.

29. This language is modified from Purchasing Associates v. Weitz, 39 Misc. 2d 262, 240 N.Y.S.2d 476 (Sup. Ct.), aff'd per curiam 19 App. Div. 2d 174, 241 N.Y.S.2d 40 (1st Dep't), rev'd, 13 N.Y.2d 267, 196 N.E.2d 245, 246 N.Y.S.2d 600 (1963). The court of appeals in a 4-to-3 decision, however, denied enforcement on the ground that there was "no evidence to support a finding either that the . . . [employee's] services are 'unique' or that the transaction . . . constitutes a 'sale' [of a business] . . . ." 13 N.Y.2d at 274, 196 N.E.2d at 249, 246 N.Y.S.2d at 606.

30. This provision is modified from Purchasing Associates v. Weitz, supra note 29. Specific performance of the restrictive covenant is justified where the services are special, unique and extraordinary. Ibid.

such remaining shares at the price and on the terms offered to such other person.[31]

31. Restrictions on share transfers are essential to the close corporation. Without them, a dissatisfied participant can blackmail his co-participants into paying an exhorbitant amount for his shares on the threat of transferring them to an unfit outsider who will inherit the transferor's management position, and, hence, a potentiality for wrecking the business.

The provision herein is a "first-option" provision, under which the shareholder desiring to sell must first offer his shares to the corporation ("entity plan"), and, if the corporation is unable (or unwilling) to repurchase, then to the other shareholders ("cross-option"), before selling to an outsider. Such first-option restrictions have been held valid. Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957), and cases cited therein. Such share restrictions contained in a shareholder agreement are binding not only on the parties but also on transferees with notice of them. Tomoser v. Kamphausen, 307 N.Y. 797, 121 N.E.2d 622 (1954).

Even if share restrictions are also contained in the certificate of incorporation and/or by-laws, it is wise to also impose them by explicit agreement.

The share restriction provisions set forth in this Article are not inconsistent with those proposed in Kessler, Certificate of Incorporation for a New York Close Corporation: A Form, 33 Fordham L. Rev. 541 (1965), and An Addendum, 35 Fordham L. Rev. 111 (1966). They are, however, more stringent, and, accordingly, should it be desired to have the certificate of incorporation mirror the agreement provisions, they should be modified in minor respects in accordance with the Addendum.

See generally, as to share restrictions, O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 Harv. L. Rev. 773 (1952); Cataldo, Stock Transfer Restrictions and the Closed Corporation, 37 Va. L. Rev. 229 (1951).

To cover a situation where the remaining shareholders approve of a sale to an outsider, non-waiver provisions to prevent the first transfer from irrevocably releasing the shares from the restrictions might be added. Hence, instead of section 10 infra, the following language might be added at the end of the paragraph:

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

Should it be desired to have a straight cross-option plan—i.e., where even the initial offer must be made to the other shareholders rather than the corporation first and alternatively to the shareholders—the following, modified from Guild, Davis & Hoxie, Stock-Purchase Agreements & The Close Corporation 70 (1960), may be used in lieu of paragraph 1: "(1) No shareholder who is a party to this agreement shall during his lifetime sell, mortgage, hypothecate, transfer, pledge, create a security interest in or lien on, encumber, give, place in trust (voting or other), or otherwise dispose of all or any portion of his shares in the corporation except that if a shareholder who is a party to this agreement should desire to so dispose of any of his shares in the corporation during his lifetime, he shall give his associate shareholders who are parties to this agreement and the secretary of the corporation written notice of such desire, and the said associate shareholders shall have the right to purchase all of his shares at any time within . . . days after such notice

(2) Any person who becomes the holder or possessor of any shares, or share certificates, of this corporation by virtue of any judicial process, attachment, bankruptcy, receivership, execution, or judicial sale, shall immediately offer all of said shares to the corporation, whenever requested by the corporation so to do, at the price herein fixed, and none of said shares shall be entitled to any vote, nor shall any dividend be paid or allowed upon any of such shares, after failure to comply with such request.[32]

(3) Upon the death of any shareholder party to this agreement, the corporation shall purchase, and the estate of the decedent shall sell, all of the decedent's shares in the corporation, and the parties hereto and the corporation shall take such action as may be necessary to permit it to make such purchase. [Title to all of said shares shall be deemed to vest in the corporation immediately upon the death of any such share-

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at the price determined by paragraph 7 of this Article. Each such associate shareholder shall have the right to purchase a proportion of such shares equal to the ratio of the number of shares owned by him to the total shares owned by the remaining associate shareholders excluding the seller, and if a shareholder is unable or unwilling to buy the proportion of shares allotted to him, the other shareholders shall have the right to buy the balance in similar ratio. [Upon the consummation of purchase and payment therefor, the secretary of the corporation shall deliver the certificates to the purchasers.]"

Although corresponding changes could be made in paragraph 2, they seem undesirable because of their complexity, and the consequent possibility that courts may be more reluctant to enforce such an obligation to make multiple and perhaps successive offers to the shareholders than one to the corporation, all combined with the relative unlikelihood of the shares falling into the hands of such outsiders because of the limitations on pledge, etc., contained in paragraph 1.

32. These provisions applying to involuntary transfers are necessary to prevent a shareholder's personal financial difficulties, real or feigned, from allowing him to foist an outsider on the business, or as a blackmail device, threatening to do so. On the other hand, some share repurchase agreements expressly provide for their termination on the bankruptcy of a party.

No guarantee of the enforceability of these provisions can be given. But see Estate Funds, Inc. v. Burton-Fifth Ave. Corp., 111 N.Y.S.2d 596 (Sup. Ct. 1952). Unless they are included, however, the agreement is almost certain to be held inapplicable to these situations. In the Matter of Trilling & Montague, 140 F. Supp. 260 (E.D. Pa. 1956).

The deprivation of dividends and voting rights here and in section 5 for violation of the agreement are, of course, merely designed to deter such violations. Although no recent New York case appears to have passed on their validity, they are widely used, see, e.g., Israels, Corporate Practice 370 (1963), and have been upheld when attacked. See 1 Hornstein, Corporation Law and Practice § 193, at 253 (1959); 2 O'Neal, Close Corporations § 7.17, at 27 (1958), and cases cited therein. They are no more severe than those which the law itself imposes on such improper transfers. For example, title to shares transferred in violation of restrictions does not pass to the transferee. Tomoser v. Kamphausen, 307 N.Y. 797, 121 N.E.2d 622 (1954). Such purported transfers are void, Hassel v. Pohle, 214 App. Div. 654, 212 N.Y. Supp. 561 (2d Dep't 1925), and, obviously, need not be recognized by the corporation by a transfer on its books, N.Y.U.C.C. § 8-401(e).

holder.] The purchase price of such shares shall be computed as hereinafter provided.[33]

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33. These provisions are designed to protect the shareholder who dies first from having the remaining shareholders (individually or through the corporation) reject the offer to repurchase in order to coerce the estate into selling at a lower price which it may otherwise be forced to do because of the limited outside market for shares of a close corporation. (Often a quick sale will be necessary to pay death taxes, and, sometimes, to secure the benefits of Int. Rev. Code of 1954, § 303.) A corresponding benefit accrues to the surviving shareholders, since they will not be forced to admit the legatees of the deceased, who often have no business experience, into the business. Such agreements are expressly validated by N.Y. Bus. Corp. Law § 514.

Paragraph 3 can also be revised to bind the remaining shareholders rather than the corporation to repurchase the shares of a deceased shareholder. The following, modified from Mutual Life Ins. Co. of New York, Business Life Insurance Agreements 86 (1965), may be used: "Upon the death of each shareholder-party, his estate shall sell all of such decedent's shares then owned, and each surviving shareholder-party shall purchase a proportion of such decedent's shares, at the price determined by paragraph 7 of this Article. The number of shares to be purchased by each surviving shareholder-party shall be in the same ratio that the number of shares owned by him bears to the total number of shares owned by all of the shareholders parties to this agreement, excluding the shares then owned by the deceased shareholder."

Since payment of insurance premiums by the corporation to enable the other shareholders to purchase its shares may constitute a taxable dividend to them, Rev. Rul. 59-184, 1959-1 Cum. Bull. 65, paragraph 8 should be amended as follows:

"In order to ensure funds to pay for the shares, insurance on the life of each shareholder will be obtained from the .... Life Insurance Company, of ...., by his associates, as follows:

On the life of ...., ... dollars, applied for by and payable to .... or his estate, and .... dollars applied for by and payable to .... or his estate.

On the life of ...., ... dollars, applied for by and payable to .... or his estate, and .... dollars applied for by and payable to .... or his estate.

On the life of ...., ... dollars, applied for by and payable to .... or his estate, and .... dollars applied for by and payable to .... or his estate.

Each applicant agrees to pay the premiums as they become due, and each policy shall be the sole and absolute property of the applicant, provided, however, that each such owner hereby collaterally assigns each policy owned by him to the insured therein as security only for the performance by each such owner of the obligations on his part to be performed under this agreement. Any dividends payable upon the policies prior to maturity by the death of the insured shall be paid to the owner in cash or disposed of as such owner may choose to direct. This agreement shall extend to and include all additional life insurance policies issued pursuant to this agreement, such additional policies to be listed in the second schedule attached hereto and made a part hereof."

This provision is appropriate where there are three shareholders. Appropriate modifications should be made if more or fewer shareholders are involved. This form is also modified from Guild, Davis & Hoxie, op. cit. supra note 31, at 69.

Provision for transfer of the policies owned by a deceased or departing shareholder on the lives of his fellow shareholders should be added here also unless a separate share restriction agreement is to be executed. The following, again modified from Guild, Davis & Hoxie, op. cit. supra note 31, at 71, can be used:

"If a shareholder during his life sells all of his shares pursuant to the provisions of paragraph 1 above, the shareholder or shareholders so purchasing such shares may purchase the policies of life insurance on his own life but owned by the withdrawing shareholder for a price not to exceed (the cash surrender value as of the date of the sale/the sum of the net premium payments made on each policy/etc.). On payment of the price by the purchaser, the seller shall assign the policy to the purchaser and shall execute such assignments or releases as may reasonably be required to effectuate a complete transfer of the title to the policy to the purchaser. On payment by the seller of the (cash surrender value as of the date of the sale/sum of the net premium payments made on each policy/etc.) of the policy on the seller's life, the seller may purchase from the other shareholder or shareholders the policy or policies on his life owned by the shareholder or shareholders so purchasing said shares, and the purchaser shall assign the policy to the seller and shall execute such assignments or releases as may reasonably be required to effectuate a complete transfer of the title to said policy or policies to the seller.

"Upon the death of a shareholder each surviving shareholder shall have the right to purchase from the estate of the deceased shareholder, and the executor or administrator of the estate of the deceased shareholder shall have the duty to sell, any policies or policy of insurance upon the life of such surviving shareholders, for a price not to exceed (the cash surrender value as of the date of death of said shareholder/the sum of the net premium payments made on each policy/etc.). Upon payment of the price the executor or administrator shall execute such assignments or releases as may reasonably be required to effectuate a complete transfer of the title to said policy or policies to the purchaser. If the insured does not, within 30 days from the sale of such shares, purchase the policy on his life, the seller or the executor or administrator may surrender the policy for its cash value and the other shareholders agree to execute such releases as may be necessary."

To insure that the endorsement required by paragraph 9 is placed on each share certificate and also to make transfers of the shares in violation of the agreement more difficult, the following provisions, modified from Guild, Davis & Hoxie, op. cit. supra note 31, at 69, might be added:

"Each shareholder shall assign his shares in blank and deposit the certificate with the secretary of the corporation who is authorized and directed to write on the face of each share certificate the following: (desired legend.) Such assignment and deposit shall not affect the right of the shareholder to vote the shares and receive the dividends thereon, except as otherwise in this agreement provided, until such time as the purchase price has been received by him or his executor or administrator under the terms of this agreement. The Secretary shall hold and deliver the shares in accordance with this agreement. No share certificate subject to this agreement shall be assigned, encumbered or otherwise disposed of during the continuance of this agreement except as provided herein." Language identical to that in V(1) may be preferable, in lieu of the last sentence.

When the entity plan is used, performance by the corporation is, of course, contingent upon availability of a surplus and solvency—i.e., the repurchase may not be made when the corporation is unable to pay its debts as they become due in the usual course of its business, nor when the purchase would render it unable to do so. N.Y. Bus. Corp. Law § 513. The agreement could, of course, be made expressly contingent upon meeting these conditions. However, they have been ruled matters of defense. See Richards v. Ernst Wiener Co., 207 N.Y. 59, 100 N.E. 592 (1912); Greater New York Carpet House, Inc. v. Herschmann, 258 App. Div. 649, 17 N.Y.S.2d 483 (1st Dep't 1940); cf. In the Matter of Farah's Estate, 13 N.Y.2d 909, 193 N.E.2d 641, 243 N.Y.S.2d 858 (1963), refusing to allow the raising of the question of the corporation's inability to perform. Thus, this would not seem necessary.

In the event of the corporation's inability to perform, the surviving shareholders could also be required to purchase the deceased shareholder's shares in proportion to their own shareholdings, using language taken from section 1.

(4) In the event that any shareholder [a party to this agreement] becomes entitled to payment of the fair value of his shares under § 623 of the Business Corporation Law, or any amendment thereto, or related or similar statute, the fair value of his shares for all purposes thereunder shall be conclusively presumed to be the price hereinafter fixed, and the shareholder shall be bound to accept any offer of the corporation to pay said amount in exchange for his shares.[34]

This expedient would also appear unnecessary, however, since neither requirement of N.Y. Bus. Corp. Law § 513 should prove a real obstacle. In the first place, the obligation to repurchase should be funded with life insurance on the life of each participant. See section 8. Even if the corporation is just "breaking even," the proceeds alone should create the necessary surplus. The additional cash on the asset side of the balance sheet will, unless the stated capital is impaired, be reflected by an equivalent increase in surplus. (If the stated capital is impaired, the excess, if any, over the impairment will be surplus, and only this excess will be available to make the repurchase.) If there is any deficiency in surplus, the stated capital of all of the shares can be reduced, thus creating a capital surplus ("reduction surplus") equal to the amount of the reduction. See N.Y. Bus. Corp. Law § 517(a)(3). (The reduction is accomplished by amendment of the certificate of incorporation under N.Y. Bus. Corp. Law § 802; by majority vote (unless a higher vote is required in the certificate), N.Y. Bus. Corp. Law § 803(a) (Supp. 1966), in a one-class situation (form of certificate of amendment: N.Y. Bus. Corp. Law § 805 (Supp. 1966)); or, alternately, in case of no-par shares by action of the board, N.Y. Bus. Corp. Law § 516(a).) The corporation and the other shareholder-parties agree to take such action under this paragraph should it be necessary.

Furthermore, the dollar amount of surplus may not need to be as great as the total repurchase price, since any shares which are repurchased will, if they are cancelled on their reacquisition, see N.Y. Bus. Corp. Law § 515(b), restore to surplus an amount equivalent to their stated capital, thus, presumably allowing additional acquisitions in a separate transaction. See Kessler, Share Repurchases Under Modern Corporation Laws, 28 Fordham L. Rev. 637, 641 n.15 (1960). Caution: if purchases are held not to be from surplus, a crime has been committed. N.Y. Pen. Law § 664(5).

Likewise, the insolvency limitation should not provide much trouble. Unless the corporation is already in financial difficulties, in which case it will be subject to the claims of creditors, the insurance should, if an adequate amount was purchased, provide enough money to pay for the shares. If there is, for some reason, not enough cash available, the provision (section 11) for installment payment should prevent undue strain on the corporation's finances. Of course, if the corporation is already insolvent when called upon to purchase the shares, it will be unable to do so, but by this time the business may already have been abandoned by all parties.

As to passing of title on death, see In the Matter of the Estate of Galewitz, 3 App. Div. 2d 280, 160 N.Y.S.2d 564 (1st Dep't 1957), aff'd mem., 5 N.Y.2d 721, 152 N.E.2d 666, 177 N.Y.S.2d 708 (1958). Transfer of title is a matter of intention, and there may be such a transfer even though the stock remains in the name of the seller. See 12A Fletcher, Corporations § 5613, at 239 (Wolf rev. ed. 1957).

The bracketed matter is optional here and elsewhere in the form. The possibly different ramifications should be considered. If the matter as to the passing of title is used, the bracketed matter in section 11 should be omitted.

34. Unless unanimity or a vote high enough to give any shareholder a veto is required by the certificate of incorporation as to such fundamental changes, a dissenting shareholder may become entitled to have his shares bought back by the corporation (out of stated

(5) No purported sale, assignment, mortgage, hypothecation, transfer, pledge, creation of a security interest in or lien on, encumbrance of gift of, trust (voting or other) of, or other disposition of any of the shares of this corporation by any shareholder [who is a party to this agreement] in violation of the provisions of this agreement, the certificate of incorporation or the by-laws shall be valid, and the corporation shall not transfer any of said shares on the books of the corporation, nor shall any of said shares be entitled to vote, nor shall any dividends be paid thereon during the period of any such violation. Such disqualifications shall be in addition to and not in lieu of any other remedies legal or equitable to enforce said provisions.

Further, the parties hereto expressly waive any voting, dividend or appraisal rights to which they would otherwise be entitled, except as herein provided.[35]

(6) Nothing herein contained shall be construed to limit or render ineffective any other provisions of this agreement, or of the certificate of incorporation or by-laws of this corporation consented to by all of the parties hereto, further restricting or conditioning the transfer of shares of this corporation, or providing penalties or disqualifications for violations of said restrictions or conditions.

(7) The value of each share of this corporation is for all purposes fixed at $...... per share. Such value includes an amount representing the good will of the corporation as a going concern. Within ...... days following the end of each fiscal year of the corporation, the shareholders [parties to this agreement] shall by unanimous mutual agreement re-determine the value of each of said shares, for the next fiscal year, and endorse said value in the Schedule to this agreement, which is made a part hereof.[36]

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capital, N.Y. Bus. Corp. Law § 513(b)(3)). The dissent, of course, may be merely a device to obtain more for his shares than he could by a straightforward offer to sell (under section 1). Since the price fixed for a voluntary repurchase (see section 7) should be a fair one, there would seem no inequity in requiring a dissenting shareholder to accept it (i.e., waive his statutory right of appraisal). Although a lower court decision has indicated that a value fixed in a shareholder agreement would not be binding in a statutory appraisal, Sands Point Land Co. v. Rossmoore, 43 Misc. 2d 368, 251 N.Y.S.2d 197 (Sup. Ct. 1964), the value set should at least be considered. It should be noted, also, that the statute favors an agreement between the corporation and the dissenting shareholder as to the price to be paid for his shares. N.Y. Bus. Corp. Law § 623(g) (Supp. 1966).

35. See note 32 supra. The corporation need not recognize a transfer in violation of the restrictions where the appropriate notice is contained on the share certificates, see section 9, under N.Y. U.C.C. §§ 8-302, 8-301, and 8-401(1)(e), and "any person" against whom the transfer is wrongful may enjoin it, N.Y. U.C.C. § 8-315.

36. Advance valuation by mutual consent appears to be the fairest method. Par or issue price is almost bound to be too low. An unchanging dollar amount is almost bound to be too high or too low. "Book value" is not as unambiguous a term as might at first appear.

In the event that, for any reason whatsoever, no such advance redetermination is made for any fiscal year, the value of each of said shares shall be the value as last fixed under this agreement increased or decreased as the case may be, by the proportionate amount, allocable to the shares whose value is being determined, of the algebraic sum of the net earnings and net losses, before all federal corporate income, state franchise, and city corporate business income taxes, of the corporation from the date of such last value until the date of the death of the shareholder, offer, or request, as the case may be.

The determination of the net earnings and losses shall be made by the corporation's regular accountant, in accordance with generally accepted accounting principles, on a basis consistent with that normally used in determining the corporation's net earnings and losses.

(8) The corporation shall purchase insurance on the life of each of the parties hereto, payable to the corporation as beneficiary, and shall pay the premiums thereon, in the respective amounts hereafter shown:[37]

See Aron v. Gillman, 309 N.Y. 157, 128 N.E.2d 284 (1955). It also tends to place greater emphasis on fixed assets, and, accordingly, does not always reflect the true value of the shares, especially in a service corporation where earnings may be great although fixed assets are small. Capitalization of earnings (earnings (known) are assumed to be a certain percentage (arbitrarily fixed by the agreement) of the value of the business (the unknown)) is not reliable until the business has been operating for a certain time. Appraisal or arbitration, although simple from a drafting point of view, leave all the uncertainties of value for resolution by the person chosen. Professor Hornstein also argues that they may have unfavorable estate tax consequences. See Kessler, Arbitration of Intra-Corporate Disputes Under New York Laws, 19 Arb. J. (n.s.) 85, 88-90 (1964).

A periodically reset dollar value has the virtue of simplicity and fairness. Should one party refuse to adjust the valuation, an alternative method of valuation must be provided, however. Drafting this alternative method of valuation is extremely difficult. One of the above methods could be chosen, but they are, of course, subject to the infirmities discussed. A formula would seem best, to avoid unfairness. On the other hand, it is extremely difficult to avoid ambiguity in any formula.

A new business will, of course, have no good will at its inception. However, silence may give ground for attack on the adequacy of the price.

As to the binding effect of the value fixed in the agreement for federal estate tax valuation purposes see Kessler, supra at 88-90.

37. Insurance is the best method for providing the corporation with the needed funds to repurchase the shares of a deceased participant. See note 33 supra. Although the tax laws must always be carefully followed, many earlier problems have been resolved favorably to the use of insurance plans for this purpose. The leading insurance companies publish pamphlets for the guidance of attorneys on this subject. Obviously, only the most recent ones should be relied upon.

Of course, a problem will arise if a participant turns out to be uninsurable. No really satisfactory solution exists for this situation. The corporation must, of course, attempt to set up its own fund for the repurchase, through regular saving. Longer term notes may have to be provided for, under section 11, or perhaps bonds or preferred stock exchanged for the voting shares. See 2 P-H Tax Ideas—Transaction Tax Guide ¶ 26002.10.

Name:	Face Amount of Policy ....
Name:	Face Amount of Policy ....
Name:	Face Amount of Policy ....
Name:	Face Amount of Policy ....

(9) All certificates for shares of this corporation shall, in addition to any notice thereon required by the certificate of incorporation or by-laws of this corporation, bear the following notice conspicuously on the face or back thereof:

"Sale, assignment, mortgage, hypothecation, transfer, pledge, creation of a security interest in or lien on, encumbrance of, gift of, trust (voting or other) of, or other disposition of these shares is restricted by the terms of a shareholder agreement dated ...., ..., which may be examined at the office of the corporation, ..."

No shares of the corporation shall be deemed properly issued, and no shares shall be transferred upon the books of the corporation, nor shall any dividends be paid thereon, nor shall the holder thereof be entitled to any voting or other rights of a shareholder, unless the certificate evidencing such shares contains said legend.[38]

Prentice-Hall, Corporation Forms ¶ 106, at 145 (1961), advises that the agreement to fund the repurchase by insurance should be separate from the share repurchase agreement. After suggesting that the purchase of insurance can be used to avoid imposition of the accumulated earnings tax, the paragraph continues: "However, the purchase of keyman insurance must be motivated by proper business purposes and not solely to prevent the imposition of accumulated earnings tax. Thus, a corporation which uses keyman insurance to fund a stock purchase agreement should not tie the two together in one agreement. Otherwise, the payments for keyman insurance may be attacked as really for the benefit of the stockholders (a disguised dividend) and not motivated by corporate business purposes."

In view of the relatively sympathetic attitude of the Internal Revenue Service toward the use of insurance to fund stock repurchases where the corporation owns the policies, pays the premiums, is the beneficiary thereunder, and makes the repurchase (as evidenced by Rev. Rul. 58-614, 1958-2 Cum. Bull. 920; Rev. Rul. 59-184, 1959-1 Cum. Bull. 65; Rev. Rul. 59-286, 1959-2 Cum. Bull. 103), such caution may be unnecessary.

38. N.Y. U.C.C. § 8-204 provides: "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." This legend is designed to meet the statutory requirement for restrictions on share transfers.

Additional legends will be required if, as it will for most close corporations, the certificate of incorporation contains high vote and quorum requirements for shareholder, and director action, and special dissolution provisions. If, as it may, the certificate contains any provision "otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all of any part of such management otherwise within the authority of the board," the existence of such provision must also be "noted conspicuously on the face or back of every certificate for shares issued." See N.Y. Bus. Corp. Law §§ 616(c), 709(c), 1002(c), 620(g), as to such notice

(10) Failure of the corporation or of the shareholders to exercise any option to purchase given under this agreement, and any waiver of any rights hereunder as to any transfer, shall not, as to any future transfer of said shares (either voluntary or by operation of law) discharge such shares from any of the restrictions herein contained.[39]

(11) Payment for all shares purchased under this agreement shall, except where the seller is a party to this agreement or the estate, executor, administrator, committee, guardian, heir, next of kin, legatee, or other legal representative of a party to this agreement, be in cash upon delivery of the share certificate or certificates properly endorsed.

Where the purchase is made from a party to this agreement, or the estate, executor, administrator, committee, guardian, heir, next of kin, legatee, or other legal representative of a party to this agreement, in lieu of payment solely in cash, payment may be made, at the election of the purchaser or purchasers as the case may be, in the following manner: (a) a down payment of ...... %[40] of the purchase price in cash, together

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requirements. See also N.Y. Bus. Corp. Law § 508(b), as to notice on share certificates where different classes of shares are issued.

The certificate and/or by-laws should require the placing of such legends on the share certificates. (See Article X of this agreement.)

39. See note 31 supra.

40. Int. Rev. Code of 1954, § 453 allows a taxpayer to report income from "a casual sale . . . of personal property" if the sale price exceeds $1,000 and, in the taxable year of sale, the payments do not exceed 30% of the selling price. Treas. Reg. § 1.453-1(c) (1966).

Obviously, to take advantage of the installment method of reporting, the down payment cannot exceed 30%. If that figure is chosen, then any payments under the notes in the year of sale will preclude installment reporting.

Where the sale takes place early in the shareholder's tax year, he may well prefer to have the payments begin promptly, even though he will have to pay a tax on his entire profit in the year in which the payments begin. This will be especially true when a short period of time over which payment of the balance is to be made is chosen (e.g., if "twelve," or less, is inserted in the blank as to the number of months during which payments on the note will extend). Under the provision set forth, the selling shareholder can demand such prompt payment.

On the other hand, if the sale takes place late in the year, or if payments on the note are to be made over a long period of time, the shareholder will probably want to waive his right to payments commencing immediately, and, instead, accept a note under which payments are not to commence until his next tax year. Since the purchaser will have longer to pay, especially if no interest is required, such a deferral should also meet with his approval.

Should it be desired to spell out these details expressly, the following might be added after the word "months": "commencing with the first month of the next succeeding taxable year of the seller, unless said taxable year begins more than 6 months after said down payment, in which case the monthly payments shall commence with the month following said down payment, ..." This will, of course, increase the complexity of the paragraph and postpone ultimate payment.

Other alternatives are, of course, possible. A down payment of 20% and monthly pay-with (b) a note or notes providing for payment of the balance in equal monthly installments (without interest) (with simple interest at ....% per annum) over a period of ...... months, with acceleration of the entire obligation in the event of nonpayment of any installment when due. [Title to said shares shall pass to the purchaser or purchasers as the case may be upon payment of the down payment, and delivery of said note or notes to the seller, and] the seller shall be bound to deliver the certificate or certificates properly endorsed for all shares to be purchased, upon tender by the purchaser or purchasers as the case may be of the down payment and note or notes as above-provided.[41]

Nothing herein shall be construed to validate a sale or other disposition of shares, otherwise prohibited by this agreement.

(12) Notwithstanding any other provision of this agreement, the office of any director and/or officer who is a party to this agreement shall immediately become vacant, and the employment of any person who is a party to this agreement shall immediately cease, and all of his rights hereunder, or under any separate employment contract, shall terminate, upon his ceasing to be a shareholder of the corporation formed hereunder. Each party to this agreement, further, hereby resigns from any office as officer, and any office as director, which he may then hold, and waives all rights under this or any separate employment contract, thereafter, effective immediately upon his ceasing to be a shareholder of the corporation.[42]

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ments of 2% of the purchase price (without interest) may prove satisfactory, and avoid complicated language. Other permutations which will not stretch out the time for payment as much are, of course, possible, but, unless the earlier monthly payments are to be less than later ones, they make less likely the availability of the installment method of reporting income. In many cases, however, the parties may prefer immediate taxability and larger payments.

Provision might be added expressly permitting prepayment by the buyer without penalty.

41. For other possible payment provisions see Israels, Corporate Practice 373-74 (1963). Under some agreements, the shares are pledged with the seller until payment in full is made. Under such an arrangement if the shares are purchased by the other shareholders, the purchasers (pledgors) can vote them "until the shares have been transferred into the name of the pledgee, or a nominee of the pledgee." N.Y. Bus. Corp. Law § 612(e). The pledgor (buyer) has the right except "when other provision shall have been made by written agreement between the parties" to receive a proxy to vote the shares from the pledgee. N.Y. Bus. Corp. Law § 609(d) (Supp. 1966). If the purchaser becomes the record owner he will presumably receive any dividends after the record date. N.Y. Bus. Corp. Law § 604. Thus, if the shares are transferred on the books to him, the purchaser can secure the principal benefits of ownership.

The pledgee (seller) could be allowed to retain voting rights through the device of an irrevocable proxy. N.Y. Bus. Corp. Law § 609(f)(1). This might have adverse effects upon a Subchapter S tax election. See Rev. Rul. 63-226, 1963-2 Cum. Bull. 341.

In any event, if the pledge device is to be used as a security device for payment for the shares, the rights of the respective parties should be spelled out with particularity.

42. Obviously, a person who is no longer a shareholder should not be allowed to retain

VI. *Dissolution*

(1) Each of the parties hereto agrees to vote all of his shares in the corporation for dissolution thereof, upon the demand of any of the parties to this agreement, upon occurrence of any of the following events (or when any of the following conditions is met):[43]

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a control position in the corporation. Where the employment contract, see Article IV, is used primarily as a bulwark to guarantee against loss of participation (control and financial) on the part of one of the organizers of the business, obviously his employment should also cease. Of course, if it is desired to retain him as a genuine employee, a new separate employment contract can be negotiated with him, or the language of this section modified to prevent the automatic termination. Since a provision for automatic vacation of office either as officer or director is more properly a certificate of incorporation or by-law provision, the language as to resignation and waiver, both of which are individual, is added. See also note 17 supra.

43. N.Y. Bus. Corp. Law § 1002(a) provides: "The certificate of incorporation may contain a provision that any shareholder, or the holders of any specified number or proportion of shares, or of any specified number or proportion of shares of any class or series thereof, may require the dissolution of the corporation at will or upon the occurrence of a specified event. If the certificate of incorporation contains such a provision, a certificate of dissolution under section 1003 (Certificate of dissolution; contents) may be signed, verified and delivered to the department of state as provided in section 104 (Certificate; requirements, signing, filing, effectiveness) when authorized by a holder or holders of the number or proportion of shares specified in such provision, given in such manner as may be specified therein, or if no manner is specified therein, when authorized on written consent signed by such holder or holders; or such certificate may be signed, verified and delivered to the department by such holder or holders or by such of them as are designated by them."

Under the usual rule that if a statute provides a particular mode for the exercise of a corporate power that method is exclusive, see In the Matter of William Faehndrich, Inc., 2 N.Y.2d 468, 141 N.E.2d 597, 161 N.Y.S.2d 99 (1957); Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945), any provision within the ambit of the statute must be incorporated in the certificate for validity. Presumably, only a requirement of less, or more (as would be required by N.Y. Bus. Corp. Law § 616 anyhow) than the statutory percentage for a voluntary dissolution as fixed by N.Y. Bus. Corp. Law § 1001 (two-thirds of all outstanding shares entitled to vote thereon) needs such a certificate implementation.

If the parties to an agreement agree to vote their shares for dissolution on terms agreed upon by them, there should be nothing objectionable about such an arrangement, which would seem to fall within the permissive scope of N.Y. Bus. Corp. Law § 620(a), the ordinary shareholder agreement section. Accordingly, an agreement to vote for dissolution upon certain contingencies should be valid, even without a certificate provision. Obviously, it will only be effective if the parties to the agreement comprise two-thirds of the shareholders entitled to vote thereon (ordinarily, two-thirds of the common shareholders). If they do, however, although this percentage is not sufficient to force inclusion of the provision in the certificate by virtue of their power to amend—N.Y. Bus. Corp. Law § 1002(b) requires unanimous shareholder consent of both voting and non-voting shares—their bargaining position may well be great enough to persuade the minority to agree to its insertion on incorporation. Obviously, if all of the participants are parties to the agreement and are in accord on the desirability of such dissolution provisions to forestall stalemate, the ap-

[A. The decision of an arbitrator, or arbitrators, as the case may be, designated to resolve any dispute between the parties to this agreement that the corporation be dissolved.][44]

[B. Upon the written request for dissolution of this corporation delivered to the other parties to this agreement by parties to this agreement who are the holders of at least ...... per cent of the total number of shares of common stock of this corporation.][45]

[C. In the event that such written offer is not accepted in writing accompanied by full payment in cash, or at the election of the purchaser or purchasers, as the case may be, a down payment of ...... per cent of the selling price and a note providing for payment in equal installments without interest over a period of ...... months with acceleration of the entire obligation in the event of nonpayment of any installment when due, by the corporation or the other shareholders who are parties to this agreement, in proportion to their then holdings in the corporation, or by one or more of said shareholders who are parties to this agreement with the consent of all other shareholders who are parties to this agreement excluding the shareholder making said offer through payment therefor in cash, within 30 days after the mailing of said offer, upon the written demand for such dissolution made to the other shareholders who are parties to this agreement by any shareholder who is a party to this agreement (including the estate of a deceased shareholder) making said written offer, for acceptance first by the corporation and then by the shareholders in the manner aforesaid on condition that the corporation not accept, to sell all of his shares (of all classes) in the corporation at a price which shall be not more than ....

propriate certificate insertion should be made, as a guarantee of enforceability. An agreement to vote for voluntary dissolution when any of the certificate provisions is met is an additional safeguard, and another example of using multiple provisions to guarantee enforcement of the desired arrangement.

The parenthetical expression may be left in or deleted, depending on the form of the events giving rise to an obligation to vote for dissolution.

44. This and the following events are possible ones which the parties may choose for giving rise to the obligation to vote for dissolution. Although the arbitrators can presumably be given the power to dissolve the corporation themselves through the irrevocable proxy device, see Kessler, Arbitration of Intra-Corporate Disputes Under New York Laws, 19 Arb. J. (n.s.) 1, 9 n.32 (1964), this provision should give an additional guarantee of the effectiveness of the arbitrators' decision. Many other possible events for dissolution could, of course, be added, e.g., the judicial invalidation of the share restrictions, or, at the behest of the remaining shareholders, any transfer of shares to outsiders which the corporation was compelled to recognize or any other event which rendered continued operation under the agreement impossible.

45. This provision is modified from 2 O'Neal, Close Corporations § 10.32a, at 151 (Supp. 1966). In the absence of a corresponding certificate of incorporation provision, the provision may be held invalid on the ground that N.Y. Bus. Corp. Law § 1002 has preempted the field.

Said demand for dissolution may be made at any time after the elapse of 30 days, but not more than 60 days thereafter, from the mailing registered mail return receipt requested, of said offer to the corporation and all of said shareholders who are parties to this agreement (or after 30 days, and not more than 60 days, following the last of such mailings, if not all mailed on the same day, but, in no event, later than 100 days after the first such mailing).][46]

[D. The death of any shareholder who is a party to this agreement (if, but only if, for any reason the shares of said deceased shareholder are not repurchased by the corporation or the other shareholders as elsewhere provided).][47]

[E. Upon occurrence of any of the conditions for dissolution set forth in the certificate of incorporation.][48]

VII. *Tax Election*

(1) The parties hereto agree that it is desirable that the corporation elect Subchapter S Federal Income Tax treatment, and accordingly agree to consent to such election, and to execute and cause the corporation to execute whatever forms are necessary to perfect said election, and to cause all of said forms and other documents necessary to be filed with the appropriate tax authorities.[49]

46. This is a "dissolution on failure to buy-out" provision. See Kessler, Certificate of Incorporation for a New York Close Corporation: A Form, supra note 31, at 575-76. Some such provision would seem to be the most desirable condition for dissolution. Preferably, a certificate of incorporation provision to this effect should be used, to insure enforceability under N.Y. Bus. Corp. Law § 1002. If the certificate of incorporation does contain all of the grounds for voluntary dissolution, ground "E" can be used in lieu of an enumeration. See also 2 O'Neal, op. cit. supra note 45, § 10.36; note 40 supra.

47. Such a provision, without the parenthetical language, should be used only if no provision is made for repurchase of a deceased shareholder's shares and even then only after careful consideration of its desirability. (It may be the only fair way of securing an adequate return to the family of the participant dying, but may prove disadvantageous to the surviving participants, and, because of a possibly limited market for the corporation's assets, even to the estate of the deceased.) It is possibly not enforceable in the absence of a certificate of incorporation provision. See note 45 supra. With the addition of the parenthetical expression it may well be advisable to protect the estate of the deceased should it be financially unfeasible to repurchase his shares. It will also prove a deterrent to attempts by the survivors to escape from their obligation to repurchase at the agreed price.

48. If this is to be the only ground, a simplification of the agreement provision could read: "Each of the parties hereto agrees to vote all of his shares of stock in the corporation for dissolution thereof, upon demand of any of the parties to this agreement, upon occurrence of any of the conditions for dissolution set forth in the certificate of incorporation." See note 43 supra.

49. All generalizations are dangerous. However, a Subchapter S tax election, Int. Rev. Code of 1954, §§ 1371-77, is probably desirable for most close corporations which can qualify, since it avoids the double taxation which was one of the principal disadvantages of

(2) Each party hereto further agrees that he will do nothing which causes or which might have the effect of causing the termination of such election, and specifically, but without limitation thereto, that he will not, directly or indirectly, terminate such election, and further that he will make no disposition of any of his shares whether inter vivos or upon death, and whether by way of sale, gift, bequest, assignment, transfer, mortgage, hypothecation, encumbrance, pledge, creation of a security interest in or lien on, trust (voting or other), or any other means whatsoever, the effect of which is or may be to terminate such election.[50]

(3) Each party further agrees to execute a will directing his executor to consent to such Subchapter S tax election within the time required to prevent its termination and to take whatever other action and execute and file whatever forms are necessary to prevent the termination of such election.[51]

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the corporation prior to 1958. Generally, corporate income and losses are "passed through" to the shareholders, whether or not profits are distributed. Obviously, such an election will not be desirable to a participant who has other sources of income which already place him in a high tax bracket, if the corporation makes a profit. He will normally prefer to pay the corporate income tax at lower rates, have the profits reinvested, and ultimately reap their benefit in his retirement years when he will be in a lower tax bracket, or pass it on, by way of the shares, to his family on his death, at estate tax rates, which with careful "estate planning" may turn out to be more favorable. On the other hand, for participants in lower income tax brackets, or where the corporation is expected to have losses, Subchapter S has a great appeal through saving the tax which would otherwise be levied on corporate profits and again when those profits were distributed to the shareholders as dividends, or, in the case of losses, allowing their use as an offset to the individual's current non-corporate income. It should be observed, however, that even without a Subchapter S election there is no corporate tax if there is no corporate net income, and hence no "double" taxation. Although salaries to participants must be "reasonable" to qualify as deductible expenses to the corporation (thus reducing its net taxable income), it is often possible, therefore, even in a non-electing corporation to escape double taxation through payment of salaries rather than dividends to participants.

If a corporation qualifies for Subchapter S, see Treas. Reg. § 1.1371-1 (1959), and elects it (all shareholders must consent), it is necessary to preserve the election from termination. (For one thing, if profits, although taxed, have not been distributed, undesirable tax consequences may well follow.) Unfortunately, termination may occur very easily. The provisions in the sections which follow are designed, so far as possible, to forestall such termination. As to Subchapter S see 1 R.I.A. Fed. Tax Coordinator, D-1500-1912 (1966).

50. Any transfer which increases the number of shareholders to eleven—counting a husband and wife owning jointly as one, however, Treas. Reg. § 1.1372-4(b)(3) (1959), any transfer to a nonresident alien, a partnership, corporation or trust, Treas. Reg. § 1.1371-1(e), or any transfer to any shareholder who does not file a consent within thirty days, Treas. Reg. § 1.1372-3(b) (1959), will automatically terminate the election. This paragraph is designed to prevent termination through limiting such transfers.

51. An estate can be a shareholder without destroying the election. However, the executor or administrator must consent. He has thirty days within which to do so. The thirty days start to run from the date of his qualification under local law "but in no event shall

(4) In the event of the death of any shareholder who is a party to this agreement, unless termination of such tax election both can be and is prevented by action of the personal representative of the deceased, the price to be paid by the corporation under this agreement for each of the shares of such deceased shareholder shall be ......, and the estate and all beneficiaries thereunder shall be bound to transfer all of said shares to the corporation at said price per share.[52]

(5) Any person who becomes the holder or possessor of any shares, or share certificates, of this corporation by virtue of any judicial process, attachment, bankruptcy, receivership, execution or judicial sale, shall take whatever action is necessary to prevent a termination of said election, and in the event that such termination nonetheless takes place, whether due to the fault of, or without the fault of said holder or possessor, the price to be paid by the corporation for each of such shares shall be ......, and the said holder or possessor shall be bound to transfer all of said shares to the corporation at said price per share, whenever requested by the corporation so to do.[53]

(6) The fact that the appropriate tax authorities revoke the termination, or allow a reelection, shall not effect the obligation of the corporation to pay no more than the amount provided for in this article of this agreement for said shares, nor validate any disposition or transfer of shares prohibited by this agreement.

VIII. § *1244 Stock*

(1) The corporation, and the parties hereto, shall take whatever action shall be necessary to cause the shares of the corporation to qualify as § 1244 Stock under the U.S. Internal Revenue Code of 1954 as amended.[54]

such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder." Treas. Reg. § 1.1372-3(b) (1959). This paragraph is designed to insure that the estate files the necessary consent in time. Although it can be argued that the estate never becomes a holder if the language as to passing of title in Article V, section 3, is inserted in the agreement, it is unwise to place sole reliance on this provision.

52. This paragraph is designed to put teeth into the direction to the executor to consent, Section 3, since, if the price paid to the estate for the deceased's shares is reduced as a result of his failure to act, the executor should properly be surchargeable. A percentage of the price fixed under paragraph 7 of Article V might be used, since, obviously, the price paid should be less than that one. If a cross-purchase plan is to be used, see note 33 supra, references to the corporation should be deleted, and reference to the shareholders added to paragraph 6.

53. Although this provision is perhaps unenforceable against outsiders, it is wise to attempt to cover all transferees.

54. Unlike Subchapter S, which may not be desirable for all close corporations, it is safe to say that all should attempt to qualify their shares as § 1244 Stock, since the conditions are easy to meet, and there are no disadvantages. Section 1244 is only of significance

if the corporation turns out to be unsuccessful. It will then allow the loss (up to $25,000, or $50,000 for a husband and wife filing jointly, in any taxable year, Int. Rev. Code of 1954, § 1244(b)) on the stock to be taken as an ordinary rather than a capital loss, with consequent tax benefits to the holder. See generally Wright, Utilization of Subchapter S and Section 1244 Stock, 12 W. Res. L. Rev. 225 (1961); 3 R.I.A. Fed. Tax Coordinator I-2900-13 (1963). All that is required to qualify, if the conditions are met, is a simple corporate resolution.

In order to qualify, the stock must be common stock (voting or non-voting) issued for money or property (i.e., not services), pursuant to a written plan, within two years after its adoption, by a corporation which, at the time of the adoption of the plan is a "small business corporation" as defined for this section (i.e., the definition is not the same as for Subchapter S).

In order for the corporation to qualify: (1) the sum of the aggregate amount which may be offered under the plan plus the aggregate amount of money and other property received by the corporation after June 30, 1958, for its stock, as a contribution to capital and as paid-in surplus must not exceed $500,000, and (2) the aggregate amount which may be offered under the plan plus the equity capital of the corporation on the date of adoption of the plan must not exceed $1,000,000. It is obvious that for most newly-formed corporations these requirements pose no obstacle.

In addition, the stock will not qualify if 50% or more of the gross receipts of the corporation for its five most recent taxable years (or since its formation, if not in existence for five years) is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. See, however, Treas. Reg. § 1.1244(c)-1(g)(2) (1960).

The only formal requirements for the plan, in addition to its being (1) in writing are (2) that it be adopted after June 30, 1958, (3) that the corporation offer only § 1244 Stock during a period specified in the plan ending not later than 2 years after its adoption, and (4) that it specifically state in terms of dollars the maximum amount to be received by the corporation in consideration for the stock to be issued pursuant to the plan. See 3 R.I.A. Fed. Tax Coordinator, I-2906—Developments (1966). There must also be no portion of a prior stock offering outstanding, i.e., unissued, when the plan is adopted.

Stock subscriptions, such as are provided for in Article I, section 2 of this agreement, will not disqualify the plan (where the other conditions are met) as long as the stock is not issued prior to the adoption of the plan. Treas. Reg. § 1.1244(c)-1(c)(3) (1960). It is essential, therefore, that the plan be adopted immediately after the certificate of incorporation is filed and immediately before issuance of any shares of the common stock.

A resolution by the board of directors should qualify as a "plan" within the meaning of the statute. See Rev. Rul. 66-67, 1966 Int. Rev. Bull. No. 12, at 9. The following should suffice:

"Whereas it has been determined to be in the best interest of this corporation and all of its shareholders that the shares of this corporation qualify as Section 1244 Stock under the Internal Revenue Code of 1954 as amended,

"Now, therefore, it is unanimously resolved that this corporation shall issue only common stock, which stock shall be Section 1244 Stock, and shall be issued during a period of time commencing with the passage of this resolution and ending on [date, not more than 2 years thereafter]; that the number of shares of said common stock to be issued shall be ....; and that the maximum dollar amount to be received by the corporation in consideration for the stock to be issued shall be $........... [the $500,000 and $1,000,000 limits mentioned above should be kept in mind]."

Since the directors are elected by the incorporator, N.Y. Bus. Corp. Law § 404(a), they may authorize the qualification of the shares before any are issued. Where under the cer-

IX. *Dividends*

The earned surplus of the corporation shall be determined quarterly by the corporation's regular accountant, in accordance with generally accepted accounting principles on a basis consistent with that normally used in determining the corporation's earned surplus, and (...... per cent) (the entire amount) of said earned surplus shall immediately be distributed to the shareholders as a dividend, in cash, provided that the corporation is not then insolvent and would not thereby be made insolvent, and provided further that the current assets of the corporation remaining after such distribution are at least ...... times the current liabilities (excluding such dividend from current liabilities).[55]

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tificate of incorporation shareholder approval is required, the incorporator or the subscribers where the incorporator "accepts" their subscriptions would appear to possess the power to pass the resolution. See N.Y. Bus. Corp. Law §§ 404(a), 616(c).

It is important to note that the ordinary loss deduction is only available to an individual to whom (or a partner in a partnership to which) the shares were originally issued—i.e., not to any transferee, not even the estate of the initial shareholder.

The tax advantages of § 1244 are obvious in a speculative venture (and most small businesses starting off fall into that category): the participants can receive favorable capital gains treatment if the venture is successful, and favorable ordinary loss treatment if it is not.

If they elect Subchapter S, the participants will not be allowed to reap the loss benefit twice. Under Subchapter S, they currently take the corporation's operating loss as a deduction. Since this reduces the basis of the stock, there will ultimately be no loss on its disposition, by the time it would qualify for worthlessness under § 1244. However, because it is so easy to qualify the stock for § 1244 treatment it is wise to do so, even where Subchapter S may be elected, just in case, for example, the election is for any reason terminated.

It should be observed, in view of the foregoing discussion, that, if the corporation is to issue any preferred stock, it should wait to do so until all of the § 1244 common stock has been issued under the plan. See Treas. Reg. § 1.1244(c)-1(h), (e), as amended, T.D. 6637, 1963-1 Cum. Bull. 139.

As to information which must be kept and filed see Treas. Reg. § 1.1244(e)-1 (1960).

55. For other possible forms see 2 O'Neal, op. cit. supra note 45, § 10.23; Kessler, supra note 31, at 581 n.93. Failure to pay dividends is a common squeeze-out device. A mandatory dividend provision is especially important in a corporation which has elected Subchapter S tax treatment for two reasons: (1) The shareholders will be individually taxed on their proportionate share of the corporation's profits even though these profits are not distributed. This may present the shareholders with the anomaly of being taxed for dividends, even though they have not received even the cash necessary to pay the tax. (2) Should termination of the Subchapter S election occur for any reason, the undistributed dividends are, in a sense, frozen, so that the benefit of the fact that the tax has already been paid on them can only be gotten after the corporation's earnings and profits have been exhausted. Thus current distribution of earnings is advisable in Subchapter S corporations. See Wright, supra note 54, at 236.

If a dividend appears unwise because the corporation needs the money for purchase of new property, the best solution is probably to have the corporation pay the dividend, anyhow, and have the shareholder use the cash to purchase the property, which can then be leased to the corporation.

X. *Management*

(1) The parties hereto agree to be bound by the following management provisions, and to insert appropriate provisions to implement them in the certificate of incorporation and by-laws of the corporation to be formed hereunder:[56]

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56. In this portion of the agreement should be set forth any provisions for high vote and quorum of the shareholders and directors. See Kessler, supra note 31, at 564-67, 569-73, or provisions delegating corporate management to the shareholders or, if desired, the officers, or one or more persons. See Kessler, Skeleton of the Close Corporation Provisions of the New York Business Corporation Law, 2 N.Y. Continuing Legal Ed. 57, 65 (1965).

Since such provisions will have to be set forth in the certificate of incorporation to insure validity, the language preferably should be exactly as it will appear in the certificate. (This language should also be repeated in the by-laws so that the participants will have there a complete guide-book to the operation of the corporation without having to flip from by-laws to certificate (even though they will, of course, be contained in the same Minute Book) to discover the appropriate rule.

If the certificate has already been prepared, the bracketed language can be used instead. If suitable by-laws are also available, so much the better. They, too, can be incorporated by reference. Although all blanks in both instruments should be filled in prior to execution of the agreement, the last sentence is designed to cover any possible oversight in this regard. Although a special provision to this effect could be added, an amendment of the certificate by mutual consent, should it for any reason be rejected by the Department of State is always possible even in the absence of such an express provision. See also Article XV, section 2.

Any other special provisions desired should probably be inserted in this part of the agreement with the title changed, perhaps to "Miscellaneous Provisions," or as separate articles with the remaining articles renumbered. An example of such a possible provision would be a general prohibition against competition by any parties to the agreement. See Article IV, section 5. That section could then be deleted. A possible form would be: "Each party to this agreement agrees that during the term of this agreement, and for a period of ...... years thereafter, he will not, directly or indirectly, for himself or as agent or employee of, or on behalf of, or in conjunction with, any person, firm, association or corporation, engage in any business or activity in competition with any business engaged in by the corporation agreed to be formed hereunder, within a radius of . . . ."

A provision might be added that no trade secrets acquired from his connection with the corporation will be disclosed or utilized by him in competition with the corporation. See also notes 28-30 supra.

If not all of the shareholders are to be parties to the agreement, it may be wise to add a provision that those who are will vote in concord to assure the effectiveness of their combined voting power. The following provision modified from Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), may suffice: "In exercising any voting rights to which any party hereto may be entitled by virtue of ownership of shares in the corporation each party will consult and confer with the others and the parties will act jointly in exercising such voting rights in accordance with such agreement as they may reach with respect to any matter calling for the exercise of such voting rights. In the event that the parties fail to agree with respect to any matter covered by this paragraph, the question in disagreement shall be submitted for arbitration to .... of .... as arbitrator and his decision thereon shall be binding upon the parties hereto [and the parties hereto further hereby agree to and do grant to the said arbitrator an 'irrevocable proxy,' pursuant to § 609(f) of the Business Corporation Law, to vote all of their shares in accordance with his decision as to any such matter to be submitted to him, which said proxy shall be irrevocable during the successive periods of any such disputes so submitted]. The parties may at any time by written agreement designate any other individual to act as arbitrator in lieu of said .... [, in which case said individual shall possess said irrevocable proxy instead]."

Such a shareholder agreement to pool votes is authorized by N.Y. Bus. Corp. Law § 620(a). In order to implement the arbitrator's decision an "irrevocable proxy" to vote the shares of all parties to the agreement, as authorized by N.Y. Bus. Corp. Law § 609(f)(5), is given to him. Presumably the proxy although characterized as irrevocable can be conditioned on its utilization only when a dispute as to how the shares should be voted has arisen. The statute, N.Y. Bus. Corp. Law § 609(g), only provides that the proxy will become revocable after the shareholder agreement has terminated.

It should be noted that the irrevocable proxy device can be used as a means of giving an officer who is not a shareholder voting power to protect his employment contract. Although renewable by execution of a new irrevocable proxy, however, a proxy given for this purpose can only be made irrevocable initially for a maximum of three years. (Of course, if the officer's employment contract is for a lesser time so must the irrevocable proxy be.)

Such a voting provision may be useful, even where all of the shareholders are parties to the agreement, where the certificate of incorporation contains a provision for unanimity on all or a large number of shareholder decisions. In such a case, the possibility of deadlock and consequent corporate paralysis through inability to reach any decision is a significant danger. Such an arbitration provision may be an effective means of breaking a deadlock on the shareholder level.

If the corporation elects Subchapter S tax treatment the irrevocable proxy provisions (bracketed in the form) should be deleted, since the device has been held to constitute a second class of stock, hence disqualifying the corporation for this special tax treatment. Rev. Rul. 63-226, 1963-2 Cum. Bull. 341. In place of the first bracketed provision the following might be inserted: ", and the parties hereto expressly consent to specific performance of said arbitrator's decision as to how their shares shall be voted by any court having jurisdiction of the subject matter."

In place of the material within the second bracket, the following might then be used: ", with the same right to have his decision specifically enforced."

Following the theory that all provisions should be bolstered by multiple enforcement devices, such consent to specific performance of the arbitrator's decision might be added even where the irrevocable proxy device is utilized.

A provision for arbitration of any disputes arising under the agreement should probably also be inserted at this point. The following provision would seem adequate: "Any dispute arising [under this agreement] [among the parties hereto] shall be finally determined by arbitration in accordance with the rules of the American Arbitration Association, in the City of New York."

Although shareholder agreements often fail to make the distinction, a provision in a shareholder agreement for arbitration may well not be applicable to disputes later on as to the operation of the corporation, where the participants are acting, e.g., in their capacity as directors (although it should be binding by virtue of N.Y. Bus. Corp. Law § 620(a) where the dispute concerns them in the capacity of shareholders). For an arbitration agreement to be binding as to directorial disputes, as to supposed wrongdoing which would ordinarily be the subject of a shareholder's derivative suit, or even on the question of whether or not the corporation should be dissolved, may well require a provision in the certificate of incorporation for enforceability. See Kessler, Arbitration of Intra-Corporate

[(1) The certificate of incorporation of the corporation shall be in the form annexed to this agreement (marked Exhibit A).

Disputes Under New York Laws, 19 Arb. J. (n.s.) 1, 11-15, 17-22 (1964). The statutes and cases should be carefully checked, since changes have occurred after the writing of that article.

Even though perhaps not held unenforceable on the ground of invalidity, a simple arbitration provision such as is set forth above may be held to be inapplicable to such disputes. It, of course, should be sufficient as to disputes as to interpretation of the meaning of the various provisions of the agreement.

It should be observed, in this connection, that provisions such as those set forth in the above-cited article, Kessler, supra note 36, at 96-97, designed to guarantee that any intra-corporate dispute which the participants desire to have submitted to arbitration will be, may well be enforceable, even though involving the participants in their director capacities, and even without a certificate provision—i.e., even though only provided for in the shareholder agreement, under a recent decision of the appellate division, First Department. In fact, even a simpler agreement provision that "any dispute arising among the parties hereto under or in any way involving this agreement or the corporation agreed to be formed hereunder, including, but without limitation thereto, its formation, operation or termination, and their interest and status therein, shall be submitted to arbitration" should be interpreted as covering any dispute even on the director level, and might be enforceable, if this case is followed.

In the case of In the Matter of Vogel, 25 App. Div. 2d 212, 268 N.Y.S.2d 237 (1st Dep't 1966), the court held that a dispute between the two sole shareholder-directors of a moving and storage corporation as to whether or not it should exercise an option to purchase the warehouse on which the corporation had a lease, was arbitrable under the provision of an agreement between the two "'to provide for their interest and status'" in the corporation, and requiring arbitration of "'a dispute, or difference, arising between them in the course of their transaction with each other.'" Id. at 214, 268 N.Y.S.2d at 239. (Emphasis omitted.) The court overruled both the objection that the question was not within the terms of the agreement, and that, if it was, arbitration of it was contrary to public policy in that it interfered with management of the corporation by its board of directors. The court, emphasizing the importance of the warehouse to the continued existence of the corporation, held that the decision as to the exercise of the option "must have reasonably been within the contemplation of the parties," and that arbitration of the question was not violative of the requirement of N.Y. Bus. Corp. Law § 701 that the business be managed by the board, since the section presupposes continued corporate existence, which might be impossible without the warehouse, and also because the decision on whether or not to exercise the option did not "require assumption of any burden of continuing management, but rather if [the corporation] . . . is to have a measure of business security and assurance of continued existence"—i.e., only a single decision. Id. at 216-17, 268 N.Y.S.2d at 242.

The director who opposed exercise of the option, and resisted arbitration, was financially interested in the corporation which owned the warehouse. The court emphasized this fact of conflicting interest, and also made the following disquieting statement: "Certainly, if all involved here were discretion and the exercise of business judgment in the management of corporate affairs it is doubtful that arbitration could be used or applied as a substitute in light of the language of the statute [N.Y. Bus. Corp. Law § 701] . . . ." Id. at 216, 268 N.Y.S.2d at 241. The court thus left grounds for limiting the case's applicability, should it be desired to do so in future cases. In view of the 3-to-2 split on the court on this decision such future limitation is always possible. Therefore, until the court of appeals passes on the matter it is safer to follow the procedure initially outlined.

The by-laws of the corporation shall be in the form annexed to this agreement (marked Exhibit B).

Any blanks in the certificate of incorporation or by-laws shall be filled in conformably to this agreement.]

XI. *Changes*

(1) No party to this agreement shall, without the consent of all other parties to this agreement (excluding the corporation) vote for any amendment or changes of the certificate of incorporation or by-laws of this corporation.[57]

XII. *Fiscal Year*

(1) The fiscal year of the corporation shall begin on .... of each year and end on ....[58]

XIII. *Parties*

(1) This agreement and any amendments hereof made in accordance herewith, including any changes in the value fixed for the shares of the corporation hereafter endorsed on the Schedule to this agreement shall be binding upon the parties hereto, their heirs, next of kin, executors, legal representatives, assignees, creditors, including judgment creditors, trustees, receivers, and all holders or possessors, or purported holders or possessors of any of the shares of this corporation, including but without limitation thereto, assignees, transferees, pledgees, mortgagees, holders of security interests in and liens upon, donees and trustees (voting and other), and all other persons with notice or knowledge, or chargeable with such notice or knowledge, of the provisions hereof.

(2) The corporation shall become a party to this agreement as soon as possible after the filing of its certificate of incorporation by the Department of State.[59]

XIV. *Term*

(1) With the exception of the employment contracts contained in this agreement, which said contracts, and the covenants not to compete thereof, shall continue in full force and effect for the periods therein provided, this agreement shall continue in force until ....,

57. This provision would seem justified by N.Y. Bus. Corp. Law § 620(a). It might, however, be held to be the equivalent of a unanimity requirement under N.Y. Bus. Corp. Law § 616, and hence unenforceable without a corresponding certificate of incorporation provision. See note 56 supra.

58. The fiscal year of the corporation should be chosen with a consideration of possible tax consequences. This provision should also appear in the by-laws.

59. It is important that the corporation become a party to the agreement to guarantee enforceability of the provisions of the agreement by and against it. This is especially important, for example, with regard to the employment contract (Article IV) and share restriction and repurchase (Article V) provisions.

19. . . ., and thereafter shall be renewed automatically for additional . . . . . . year periods, unless at least 30 days before . . . . of the year in which this agreement or any renewal thereof would otherwise expire, any party hereto shall give written notice of his desire to have the agreement terminated on . . . . of such year. Any such notice shall be given by registered or certified mail return receipt requested addressed to all of the parties hereto at their addresses given below.[60]

(2) Should any one or more of the individual parties to this agreement die before the filing of the certificate of incorporation of the corporation agreed to be formed hereunder, however, this agreement shall automatically terminate, and all parties shall be released from all obligation hereunder.[61]

XV: *Interpretation*

(1) References to this agreement herein shall include any amendment or renewal thereof. References to the term of this agreement shall include any renewal thereof.

(2) This agreement contains the entire agreement of the parties with respect to its subject matter, and no amendment, modification, or waiver of any provision hereof shall be valid unless in writing and signed by all of the parties hereto.

(3) The parties to this agreement, in addition to all other remedies allowed by law for its enforcement, expressly consent to its specific performance in any court having jurisdiction.[62]

(4) This agreement is to be construed in accordance with the law of New York.

(5) If any provisions of this agreement are held invalid or unenforceable, such invalidity or unenforceability shall not affect the validity or enforceability of the other portions hereof, all of which provisions are hereby declared severable.[63]

60. It is simpler to provide for automatic renewal of the agreement upon inaction, than to impose an obligation for action on the participants to continue the agreement in force.

61. The death of one of the active participants early in the life of the venture is certain to cause upheaval, and, perhaps, the desire to "call the whole thing off." The latter is almost certain to be the case if the death occurs before the business is even set up. The termination of the agreement does not necssarily mean the death of the venture. It will, however, give the remaining participants time to secure another person with similar abilities to replace the deceased party.

62. Damages are ordinarily an inadequate remedy. A number of cases have upheld specific performance of shareholder agreements. See, e.g., Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup. Ct.), aff'd mem., 282 App. Div. 950, 125 N.Y.S.2d 339 (2d Dep't 1953); Simonson v. Helburn, 198 Misc. 430, 97 N.Y.S.2d 406 (Sup. Ct. 1950).

63. A severability clause is advisable to prevent the entire agreement from being struck

(6) It is the design of this agreement that the corporation be operated by the parties to this agreement and for their mutual benefit, and to the exclusion of outsiders, and to that end, the parties hereto further agree, for themselves and in behalf of the corporation to take whatever other action shall be necessary to effectuate the purposes of this agreement.[64]

In Witness Whereof the parties hereto have hereunto set their hands and seals the day and year first above written.

.... L.S. (name)	.... (address for notices)
.... L.S. (name)	.... (address for notices)
.... L.S. (name)	.... (address for notices)
.... L.S. (name)	.... (address for notices)

Adopted, accepted, confirmed and agreed to:

(Seal)
Attest:

(Name of corporation)
By:

....
(name)
President

....
(name)
Secretary

Date: ...., .., 1966.

Schedule

For fiscal year beginning:	*Value fixed for each share under this agreement*:	*Consented to, Date*:
.... , 19..	$	................, ../../.. (name) ...., ../../.. (name) ...., ../../.. (name) ...., ../../.. (name)

down should a portion of it be held unenforceable. See In the Matter of Abbey, 274 App. Div. 389, 83 N.Y.S.2d 503 (1st Dep't 1948), aff'd mem., 299 N.Y. 557, 85 N.E.2d 789 (1949).

64. In the past many close corporation arrangements have been upset by the courts at the behest of a party to the arrangement who has decided that it is advantageous to break his word, or, more charitably, has changed his mind. This final paragraph is again designed to make clear the purpose of the agreement, and its acceptance by all of the parties, in the hope that, if ever called upon to interpret it, the courts will do so in accordance with its spirit.