

Purposes and Legal Support
Concentration of Voting Power
Share Transfer Restrictions and Buyout
Agreements

AGREEMENTS REGARDING OWNERSHIP

PURPOSES AND LEGAL SUPPORT

The close corporation has been discussed in a previous chapter.¹ The close corporation is usually owned by a small group of shareholders, who also may be the acting management of the corporation. The control exercised by the shareholders is a significant characteristic of this special corporate form, and this exclusive control may be protected by various provisions and agreements that prevent the sale of stock to persons outside of the select shareholder group. **Share transfer restrictions** are designed to preserve present ownership interests. These restrictions may be drafted as a limitation upon the capital stock structure in the articles of incorporation or may be the subject matter of a shareholder agreement to which all of the shareholders and the corporation are parties.

Agreements among members in a limited liability company and among partners in a partnership also may involve ownership and transfer of the equity interests of the entity or association. Although this chapter is concerned primarily with ownership agreements among shareholders, the principles and drafting techniques described here may be used with partnerships and limited liability companies as well.

Restrictions on the transfer of shares are recognized as a viable and legal way to retain ownership control among a closed group of people, with one important limitation. Since corporate shares are personal property of the shareholder, and since the law will not enforce an agreement that completely nullifies property rights, an agreement restricting the transfer of shares may not completely and irrevocably prohibit the sale of the stock. An agreement may, however, impose all sorts of restrictions that discourage sale to outsiders, and it may require that the shares must first be offered to the corporation or the other shareholders before they may be sold elsewhere. Although the selling shareholder must be able to sell the stock in the end, the shareholder may be required to satisfy a maze of conditions before doing so.

There are also shareholder agreements designed to concentrate voting power, with a group of shareholders pooling their votes under a contract that prescribes in advance how their shares will be voted on certain matters. Whatever control can be wielded by the concerted action of the total shares represented by the agreement will be applied to a vote on the specified corporate issues. The typical issues covered by shareholder voting

agreements include the election of directors, amendments to the articles of incorporation, mergers, share exchanges, dissolution, and sales or other disposition of assets. Although these agreements are not unique to close corporations, they may be used in that setting to establish a predetermined voting position on matters such as salaries and dividends, especially where the shareholders also are employees of the corporation and are receiving salaries in lieu of dividends.

Shareholder voting agreements are commonly used to protect minority shareholders from abusive action by the majority shareholders. Recall that there are other provisions, statutory and by agreement, that protect the minority shareholders from the dangers of oppressive majority control. Cumulative voting is specifically designed to ensure minority shareholder representation on the board of directors (but an agreement among minority shareholders may be necessary to effectively utilize cumulative voting).² The articles of incorporation may require greater-than-majority voting requirements for shareholder action. For example, if the articles of incorporation require a 90% affirmative vote on all shareholder matters, an 11% minority shareholder could effectively veto any unwanted action. However, the majority shareholders may not appreciate this, and the incorporators must consider the potential dissatisfaction of majority shareholders when the articles are drafted. After all, the majority shareholders do invest the majority of capital. Some state statutes require a greater-than-majority vote for major changes in the corporate structure, such as amendments to the articles of incorporation, merger, and so forth,³ and the minority shareholders receive some protection against modifications to their ownership interests in the corporation. Finally, judicial decisions support a cause of action by the minority shareholders against majority shareholders for oppression of the minority interest, but it is far more desirable to avoid that oppression through concentrated voting power rather than by litigation.

The Model Business Corporation Act grants statutory authority for shareholder voting agreements. Section 7.31 states that such agreements shall be valid and specifically enforceable according to their terms, meaning that a court may order a party to the agreement to perform his or her obligations under the agreement. Common law has long recognized the ability of shareholders to predetermine their position by agreement on normal shareholder business, such as electing directors. A rule has developed, however, that discourages any shareholder agreement that impinges on the statutory rules or usurps the power of the board of directors. For example, shareholders cannot agree that a quorum for shareholder meetings shall be one-fourth of the total voting shares, since the minimum allowable by statute is one-third in most jurisdictions.⁴ Similarly, a shareholder agreement that a particular person will be continuously maintained as an officer of the corporation may be ineffective because the authority to select officers belongs to the directors. The Model Act and several states have adopted statutory rules that would permit the latter agreement, but further add that the shareholders must bear full responsibility for managerial acts governed by their agreement.⁵

Leaving aside agreements that encroach upon director discretion or regulate other managerial acts, there is no question that shareholders may agree regarding the manner in which their shares will be voted on issues normally requiring shareholder action.

CONCENTRATION OF VOTING POWER

In addition to the statutory and chartered rules that protect the minority interest (cumulative voting and greater-than-majority voting requirements), shareholders may pool their votes in an agreement executed among themselves, and thereby concentrate their aggregate voting power on each shareholder issue. There are formal ways and informal ways to do this. The formal voting trust ensures a more reliable concentration of power, since it prevents the possibility of a divided position from a shareholder who subsequently decides to act independently, but the voting trust must comply with the requirements of state corporate statutes. The informal voting or pooling agreement is much easier to use and may exist for longer periods of time, but it may not be as effective to control voting.

The following chart describes the important distinctions between voting trusts and pooling agreements:

| <i>Voting Trust</i> | <i>Pooling Agreement</i> |
|--|---|
| Must be in writing | May be informal, but most statutes require a written agreement |
| Separates legal and beneficial ownership of shares | Each shareholder remains the legal owner of the shares |
| Must be a limited time (usually ten years) | May agree to last any period of time |
| A copy must be deposited with the corporation for the trust to be effective | No requirement for deposit with the corporation (may be a secret) |
| Ensures voting control because the trustee is the person who will cast the vote for all shares represented | Will require court action to enforce the agreement if a shareholder votes in violation of the agreement |

Voting Trust

The formal approach to the concentration of shareholder voting power is a device called the **voting trust**. Voting trusts are permitted under the Model Business Corporation Act and in most jurisdictions, and the statutory requirements must be strictly followed. The voting trust is a trust arrangement in every sense of the term. The shares represented by this agreement are placed in trust, out of the hands of the shareholders, and a designated voting trustee is directed to vote the shares represented by the trust in accordance with the terms of the agreement. The duration of a voting trust is limited to a period of ten years under the Model Business Corporation Act.⁶ A few states increase the term to fifteen years,⁷ and a couple permit a twenty-one-year period.⁸ Extensions for an additional period of ten years are permitted in the Model Business Corporation Act and in several jurisdictions. The shareholders who are parties to a voting trust surrender their shares to the trust and the voting trustee becomes the record owner of those shares, thereby ensuring that the trustee is notified of every shareholder meeting and that the trustee will have the legal right to vote the shares at such meetings. This is the “legal ownership” interest. The shareholder is issued a voting trust certificate representing the shares of stock he or she once held and is entitled to receive all distributions from the shares. This is the “beneficial ownership” interest. Voting trust certificates may be as transferable as the stock certificates themselves, although the purchaser takes them subject to the terms of the trust, which are stated on the certificate. The certificate also states the name of the trustee and other important matters respecting the agreement.

Under the Model Business Corporation Act, a voting trust becomes effective on the date that the first shares subject to the trust are registered in the trustee’s name.⁹ To meet the specific statutory requirements of most states and the act, the trust must be established as follows:

1. A written trust agreement must be prepared specifying the terms and conditions of the trust and conferring upon the trustee the right to vote the shares represented by the trust;
2. The shares represented must be transferred to the trustee in return for voting trust certificates;
3. The term of the agreement shall not be more than the statutory period, usually ten years;
4. The trustee must keep a record of all beneficiaries (shareholders) with their names and addresses and the number of shares deposited with the trust; and
5. A counterpart of the trust agreement and the record of beneficiaries must be deposited with the corporation at its principal office.

Several jurisdictions omit the requirement that the trustee maintain a record of beneficiaries.

The voting trust agreement must strictly observe the statutory requirements; a failure to do so may invalidate the trust. The agreement should specify its duration (within the statutory limit) and may provide for termination at any time by a prescribed vote of the beneficiaries. The designation of the trustees should state any qualifications the parties intend to impose, such as requiring the trustees to be shareholders or prohibiting any director of the corporation from acting as trustee. The description of authority should carefully detail the power of the

trustees to vote the stock, naming specific issues if the trust is so limited, or granting total voting power of the stock to the trustees. The decisions of the trustees may be based upon the trustees' good judgment, or the agreement may require that the trustees obtain the consensus of a certain percentage of the beneficiaries before casting the trust vote. The trustees should be excused from liability for their actions, except for gross negligence, and should be indemnified for expenses and liabilities incurred in the exercise of their trust power. The procedure for the transfer and issuance of voting trust certificates must be detailed. Finally, ministerial duties of the trustees in receiving and paying dividends of the stock, filing documents with the corporation, and recording voting trust certificates may be specified.

A sample voting trust agreement with a voting trust certificate is Exhibit J-12 in Appendix I.

Stock Voting Agreement

Another agreement designed to concentrate shareholder voting power is a voting or pooling agreement, which may accomplish the same purpose as the voting trust, but usually is not subject to the same statutory regulation. Several shareholders join together and pool their respective voting interests, predetermining the manner in which the shares will be voted by the agreement.

Stock voting agreements may be quite informal and may vary depending upon the desires of the parties, since there is virtually no statutory regulation governing their formation and interpretation. Section 7.31 of the Model Business Corporation Act simply states that "two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose." Voting agreements that are created under section 7.31 are not subject to the rules concerning voting trusts in section 7.30. In principle, then, a stock voting agreement can last indefinitely, as contrasted with the voting trust, which has a limited term. The voting agreement also may be a secret, if that is desirable, since no evidence of the agreement need be deposited with the corporation.

Stock voting agreements have traditionally suffered from one serious deficiency: a lack of enforceability. Unlike voting trust agreements, stock voting agreements do not require shareholders to deposit their shares with anyone. The shareholders merely agree to vote the shares, which they still control, in the same manner as do the other parties to the agreement. Suppose Wagner, Naylor, and Shaklee enter into a stock pooling agreement that they will vote the same way on shareholder matters and that the manner in which they vote will be determined by a majority vote among them. Suppose further that on a given issue Wagner and Naylor want the votes cast one way, but Shaklee dissents. If Shaklee refuses to abide by the decision, he may still cast the votes he controls in any way he wants. The other parties may be able to sue him for breach of the pooling agreement, but the most important objective, the concentrated voting power, has been lost on that issue. This situation cannot occur with a formal voting trust. In an effort to solve this problem, the Model Business Corporation Act provides that a voting agreement will be specifically enforceable, meaning that a shareholder can be required by a court to cast his or her vote in conformity with the agreement. Several states have also adopted this provision.

Another problem unique to the voting agreement arises if one of the parties to the agreement decides to sell the stock. The concentrated voting power is lost if the purchaser is not obliged to abide by the agreement. A typical response to this problem is to impose a restriction on the transfer of stock held by the parties to the agreement, requiring that an offer to sell the stock be directed to the other parties before the shares may be sold to a nonparty investor.

Restriction on Transfer of Stock

Neither party will sell any shares of stock in the corporation to any other person whomsoever, without first making a written offer to the other party hereto of all of the shares proposed to be sold, for the same price and upon the same terms and conditions as in such proposed sale, and allowing such other party a time of not less than 180 days from the date of such written offer within which to accept same.

EXAMPLE

The stock voting agreement requires joint action of the participants in exercising their voting rights. The joint action may be required on all matters submitted to the vote of the shareholders, or may be limited to certain issues where concentration of voting power is deemed to be important, such as amendments to the articles, election of directors, and so forth. An example of a joint action clause covering all shareholders' matters looks like this:

EXAMPLE

Joint Action

In exercising any voting rights to which either party may be entitled by virtue of ownership of stock held by them in the corporation, each party will consult and confer with the other, and the parties will act jointly in exercising the voting rights in accordance with such agreement as they may reach with respect to any matter calling for the exercise of the voting rights.

The determination of how the votes will be cast is made by agreement of the participants; if there are more than two parties to the agreement, a formula should be prescribed for this determination. For example, the agreement can require the unanimous vote of the shareholders represented by the agreement, although this criterion may be impossible to satisfy. A provision allowing the determination of position to be made by a majority of the shares represented by the agreement is more practicable. If a deadlock is possible under the agreement, as it might be if only two shareholders are parties, a provision regarding arbitration or another settlement mechanism, such as mediation, is appropriate.

EXAMPLE

Arbitration

In the event the parties fail to agree with respect to any matter covered by the preceding paragraph, the question in disagreement shall be submitted for arbitration to D. S. Charlton, of Montgomery, Alabama, as arbitrator, and his decision thereon shall be binding upon the parties hereto. Such arbitration shall be exercised to the end of ensuring good management for the corporation. The parties may at any time by written agreement designate any other individual to act as arbitrator in lieu of said D. S. Charlton.

Duration and termination provisions should be included, reflecting the desires of the parties as to such matters.

EXAMPLE

Duration

This agreement shall be in effect from the date hereof and shall continue in effect for a period of twenty years unless sooner terminated by mutual agreement in writing by the parties hereto.

Agreements to Secure Director Representation

Since corporate management is vested in the board of directors and the board of directors is elected by the shareholders, the board is usually elected by the majority shareholders, particularly when cumulative voting is not in effect. Even if cumulative voting is used in the election of directors, the minority shareholders may have to unite to secure representation of the board.¹⁰ Consequently, the minority shareholders frequently are not represented on the board of directors.

An assurance of minority representation on the board may be accomplished by agreement in two ways. With the first method, using the concentration of minority voting power, a shareholder voting agreement or voting trust may predetermine the manner in which the parties to the agreement will vote at the election of the directors. The terms of this agreement would provide that all parties to the agreement (or the trustee) would vote for a person who, according

to a majority of the persons represented by the agreement (or other formula determination), would best represent the interests of the parties. With the second method, there would be an agreement among all shareholders that certain positions on the board of directors would be reserved to the nominee of the minority shareholders, and that all shareholders would vote to elect the **minority nominee** to the board at each election.

Agreement to Segregate the Board of Directors

EXAMPLE

That the number of the members of the Board of Directors of Trouble, Inc., be reduced from five, as it now is, to the number of four, that the number of members of said Board of Directors shall be maintained at four in number, of which at all times two thereof shall be such persons as shall be nominated or designated by the said parties of the first part and the other two thereof shall be such persons as shall be nominated or designated by the said party of the second part. And it is further mutually agreed between the parties that at all stockholders' meetings of the said Trouble, Inc., held for the purpose of election of directors or director (in case of vacancy of the Board of Directors), that all of the said shares of stock of parties of the first part and also of party of the second part and also any additional shares of stock of Trouble, Inc., which may be subsequently acquired by the said parties or either of them, shall be voted in such manner and for such person or persons as will keep and maintain the Board of Directors four in number, of which two thereof shall be such persons as shall be nominated or designated by said parties of the first part and two thereof shall be such persons as shall be nominated or designated by the said party of the second part.

Instead of the general description “minority nominee,” it is possible to name a certain person in the shareholder agreement and agree that he or she will be continually elected as a director to represent the specialized shareholder interests. However, these agreements have been subjected to careful scrutiny by the courts and have been declared invalid if they fail to leave room for the defeat of an incompetent director. On the other hand, a shareholder agreement will be enforceable if it states that a named director will be maintained in office as long as that person faithfully and conscientiously performs the duties of that office. Therefore, it is good practice to include a **savings clause**, making the election of a particular director obligatory only if that person is competent to serve in that position.

Agreements Concerning Management Issues

Although the traditional rule of corporate law is that the shareholders cannot enter into agreements that may interfere with or usurp the authority of the board of directors, modern corporate statutes acknowledge that the shareholders should be entitled to enter into agreements among themselves about certain management issues of particular importance to them. Certainly partners in partnerships and members of limited liability companies can agree on management issues (and, in fact, are expected to address such issues in their agreements), so it is reasonable that the shareholders of closely held corporations should be allowed to do the same.

Section 7.32 of the Model Act provides statutory guidance for shareholder agreements on certain management issues. That section specifically authorizes agreements that

1. eliminate the board of directors or restricts its power;
2. authorize distributions to the shareholders (which may be disproportionate to the ownership of shares but subject to the solvency limitations on distributions);
3. determine the identity and terms of the directors and officers (and how they will be selected or removed);
4. govern how voting will occur among shareholders and directors;
5. establish terms and conditions of any agreement involving property or services among the corporation and its shareholders, directors, or employees;
6. transfer to a shareholder or other person corporate authority under certain described circumstances;

7. require dissolution of the corporation at the request of a shareholder or on a specified event;
8. otherwise govern the exercise of corporate powers or management of the business, so long as it is not contrary to public policy.

For such an agreement to be valid, it must be set forth in the articles of incorporation or bylaws and approved unanimously by all shareholders or must be in a written agreement that is signed by all shareholders. Thus, like partners who are parties to a partnership agreement or members who enter into an operating agreement for a limited liability company, the shareholders of a closely held corporation may agree on their management structure and responsibilities differently than the normal rigid corporate divisions of authority. The Model Act adjusts other corporate rules for that privilege, however, and provides that any such agreement that limits the discretion or powers of the board of directors shall relieve the directors of any liability for decisions made pursuant to the agreement. There is also a limitation on the duration of such agreements (ten years) unless the agreement expressly provides otherwise. Further, the existence of such an agreement must be conspicuously noted on the certificates for shares to warn purchasers of such shares that the structure of the corporation has been changed by the agreement. If the notation on the certificate was omitted and a purchaser of shares was not aware of the agreement, the purchaser can rescind the purchase of shares on that basis.

SHARE TRANSFER RESTRICTIONS AND BUYOUT AGREEMENTS

Shareholder agreements frequently are concerned with restrictions on the transfer of shares. These restrictions are not necessarily directed to the protection of special shareholder stock voting agreements. Usually the restrictions on transfer are intended to protect all shareholders who desire to avoid alienation or interference with corporate control. Minority shareholders could suffer greatly if majority shareholders were allowed to sell their shares and the associated control of the corporation to an outsider who is not sympathetic to the minority interest. Similarly, majority shareholders could suffer from the sale of even one share to a recalcitrant, argumentative shareholder, particularly in a close corporation where all of the shareholders must work closely to further the enterprise.

Restrictions on transfer of shares may be imposed in the articles of incorporation, the bylaws, or separate shareholder agreements. The corporation is usually a party to the restrictive agreement because the agreement usually grants the corporation the right to repurchase shares if a shareholder wants to sell them. The thrust of most restrictive agreements is to prohibit the transfer of shares to an outsider without first offering them for sale to the corporation or to the other shareholders.

Agreements affecting share ownership may specify **mandatory buyout or sellout arrangements**, directed to the corporation and the shareholders, but the objectives here are opposite from those of the share transfer restrictions. While share transfer restrictions are intended to discourage the transfer of shares, mandatory buyout or sellout arrangements are designed to require the transfer of shares. The intracorporate groups may prefer to prohibit share ownership by a person who is not actively engaged in the business, and a mandatory sellout agreement may satisfy this objective. On the other hand, a shareholder may wish to ensure the existence of a market in which to sell his or her shares, which can be accomplished through a mandatory buyout agreement. In small, closely held corporations, the shares may not be marketable, and without a mandatory buyout agreement, a shareholder has no choice but to hold the shares indefinitely with no prospect of receiving a return of invested capital until the corporation is dissolved. Finally, a mandatory buyout agreement also ensures that a deceased shareholder's heirs will receive the agreed value of the shares when a shareholder dies.

Restrictive Agreements

Section 6.27 of the Model Business Corporation Act provides statutory authority for an agreement among shareholders concerning restrictions on the transfer of shares of the corporation.

The restrictions may be contained in the articles of incorporation, the bylaws, or a separate agreement. The share transfer restriction is authorized

1. to maintain the corporation's status when that status is dependent on the number or identity of the corporation's shareholders (such as when a corporation makes a Subchapter S election for tax purposes);
2. to preserve exemptions under federal or state laws (such as when a corporation offers shares privately to shareholders and does not register the shares with the Securities and Exchange Commission so the restriction prevents shares from being transferred to the public); and
3. to accomplish any other reasonable purpose.

The validity of a share transfer restriction depends, in part, upon the nature and structure of the business. The restriction must be adopted for a lawful purpose, and it may be necessary to show that there is a special need for a share transfer restriction in the particular type of business or in the particular relationship between shareholders. This burden should not be onerous, but it should be considered when a share transfer restriction is adopted by the parties. There is ample reason to support the restriction in small, close corporations, but in any case, the agreement should recite that its purpose is to further harmonious relations between the parties and to promote the best interests of the business.

The most effective way to ensure that no outsider will be admitted to a select shareholder group would be to completely and forever prohibit the sale of the stock to any person at any time. Such a complete prohibition on transferability is certainly restrictive, but it is also unenforceable and against public policy. Agreements that indefinitely prohibit the exercise of personal rights are presumed to be unfair, and it is virtually impossible to muster any rational reason to support such a severe restriction.

The most common restriction used to control the transfer of shares grants the corporation or the other shareholders the first option to purchase shares before those shares may be sold to an outsider.

Events Triggering the Restriction A stock transfer restriction is normally triggered when a selling shareholder has received a valid and sincere offer to purchase his or her shares. If the agreement does not provide for some method of determining whether an offer is valid and sincere, a shareholder may manipulate the agreement. If the shareholder gives notice of an intention to sell the shares, the corporation and the other shareholders must either buy the stock or run the risk that the stock will be free from any transfer restriction. Thus, some definition of a **good faith offer** to purchase should be included in every restriction. Several possibilities exist for establishing the validity of an offer:

1. The agreement should provide that the offer to purchase the shares from an outside investor should be in writing.
2. The agreement may provide that the good faith offer must be supported by an earnest-money deposit.
3. The agreement may provide that the good faith offer must be supported by an escrow of the total purchase price, the terms of which would provide that in the event the corporation or the other shareholders fail to purchase their proportionate share of the selling shareholder's stock, the escrow proceeds would be distributed automatically to the selling shareholder and the stock would be deemed to have been purchased at that time.
4. The agreement may or may not provide for the disclosure of the identity of the good faith purchaser. On the one hand, disclosure of the identity of the purchaser will affirm the existence of a real purchaser and help the other shareholders to decide if they are comfortable having the purchaser as a fellow shareholder. On the other hand, if the corporation and the other shareholders know the identity of the purchaser, they might attempt to thwart the sale or sell other shares to the identified purchaser, thereby discouraging the purchase from the proposed selling shareholder.

EXAMPLE**Bona Fide Offer**

Upon receipt of a bona fide offer to purchase the shares by a person not a shareholder of the corporation, a selling shareholder must follow the restrictions contained in this article prior to selling any shares of stock to the offeror. A bona fide offer shall require that the offeror place an amount equal to the purchase price of the stock in escrow, the terms of which shall require the release of said funds for the purchase of the stock if the corporation and other shareholders do not exercise their options hereunder, and contain an agreement from the offeror to be bound by the terms of these restrictions upon purchase of such shares.

Other events also may be the subject of a stock transfer restriction that prevents the free transferability of shares under certain conditions. For example, the restriction may require that on the death of a shareholder, the heirs or representatives of the deceased shareholder must offer the shares to the corporation or to the other shareholders. Similarly, retirement, disability, bankruptcy, or loss of a professional or occupational license necessary to the business of the corporation (as in a professional corporation) may trigger a stock transfer restriction. In these cases, however, it is likely that the agreement would provide for a mandatory purchase or sale upon the happening of the event. These mandatory agreements are discussed in detail later in this section.

Option to Purchase The usual **option-to-purchase** share transfer restriction requires that an offer to sell be directed first to the corporation, which has a right of refusal, and then to the other shareholders, who also have the right of refusal to purchase the shares. If both the corporation and the shareholders decline to purchase the shares, then the selling shareholder may sell to the outsider. Alternatively, the restriction may run only to the corporation, or may bypass the corporation and grant the option to purchase only to the other shareholders. When the other shareholders are granted the option to purchase, the shares usually will be offered to them in the same proportion as their present ownership interests in the corporation.

An example of a provision granting a right of refusal to the corporation and then to the remaining shareholders follows.

EXAMPLE**Option to Purchase Shares**

Should any shareholder wish to dispose of his or her stock, it shall first be offered to the corporation at a price no greater than a bona fide offer by any third person, and said stock shall be available to the corporation for a period of thirty days. In the event that any of the said stock is not purchased by the corporation, it shall be offered to the remaining shareholders of the same class of stock in the same proportion as their respective stock interests in said class of stock, for a like price and for a similar period of time. In the event any of the remaining shareholders declines to purchase his or her proportionate share of said stock, that share shall be offered to the then remaining shareholders of the same class of stock for a like price and for a similar period of time. In the event that any of said stock is not purchased by the corporation or the shareholders, the remaining stock may then be sold by the shareholder at the price of the bona fide offer of the third person.

By way of illustration, suppose the Nobles Company has three shareholders; Dworet, who owns 100 shares, Rezabeck, who owns 200 shares; and Weiler, who owns 300 shares. If Dworet desires to sell her shares and receives a bona fide offer for the purchase, she must first offer to sell the shares to the corporation at the price determined by the formula, and the corporation shall have thirty days to reject or accept the offer. If the corporation rejects the offer, Dworet must then offer the shares to Rezabeck and Weiler, who own the same class of stock in a 2:3 ratio, since Rezabeck owns 200 shares and Weiler owns 300 shares. Rezabeck and Weiler may then purchase in that ratio, meaning that Rezabeck can purchase 40 shares and

Weiler can purchase 60 shares. If Rezabeck declines to purchase the shares to which she is entitled, those shares must then be offered to Weiler, or vice versa, according to the sample provision. Only if the corporation and the other two shareholders decline to purchase the shares may Dworet sell the shares to the outsider.

Any variations in this scheme are permissible.

Considerations in Designating the Option to Purchase There are a couple of practical observations to consider in drafting the restriction. The first offer to the corporation is desirable because a solvent and profitable corporation will probably have funds legally available to purchase the shares. Moreover, it is more convenient to make the offer to the corporation through a single notice than to notify all of the other shareholders. The remaining shareholders also may prefer that the purchase funds come from internal corporate operations rather than attempting to raise funds individually. However, there may be situations when the corporation is not permitted to buy its own shares because of statutory restrictions on the funds that must be used for that purpose. If the corporation is unable to meet the statutory restrictions on distributions to shareholders, the corporation must refuse the offer, and to preserve the viability of the restriction, the offer should then run to the individual shareholders.

If the corporation is going to exercise an option to purchase or redeem its shares, it must do so in strict compliance with statutory restrictions on funds available for repurchase. Provided the corporation is solvent (and the purchase of shares will not render it insolvent), in many states the corporation may purchase its own shares only to the extent that it has unreserved and unrestricted surplus.¹¹ Under section 6.40 of the Model Business Corporation Act, the corporation may acquire its own shares as long as the funds distributed for the purchase will not reduce the corporation's net assets below the aggregate amount payable to shareholders with liquidation rights upon involuntary liquidation and dissolution of the corporation.¹² The surplus requirements under the applicable statute have nothing to do with the availability of cash to effect a repurchase, except insofar as the corporation must be able to pay its debts and liabilities as they fall due after distributing cash to the selling shareholder. The corporation may have sufficient cash for the stock purchase, but substantial current liabilities, or there may be only a few debts due on the corporation's books, but no ready cash.

The corporation may use life insurance as a method of funding a buyout agreement, especially when the event triggering the buyout is death. Life insurance funding also may be used when the triggering event is retirement, disability, or termination of employment. These funding options are discussed in detail later.

The remaining shareholders may find that raising funds to buy out a withdrawing shareholder is a difficult task, particularly if they must come up with the cash immediately on a shareholder's death or some other triggering event. The problem may be alleviated if the agreement provides for installment payments.

The agreement should permit those who elect to purchase more than their pro rata shares to divide equitably among themselves any shares not taken on the first division. If some shares still remain, the agreement should provide whether the original number or only the untaken shares may be sold to an outsider. Another question is whether the selling shareholder may break his or her stock holdings into small blocks and offer them to several people, thus obtaining a higher price per share. If the parties wish to eliminate these possibilities, the agreement should specifically prohibit such actions.

All or Nothing Purchase A choice must be made at the drafting stage between a restriction permitting a partial purchase of the offered stock or one requiring a purchase of **all or nothing**. Continuing with the example of the Nobles Company, presumably Dworet has received an offer from an outsider to buy her 100 shares at a price. The question now is whether the corporation or the other shareholders may purchase only a portion of her 100 shares in exercising the right of first refusal, or whether they must buy the entire block to exercise the option. Dworet is better protected if they must buy the entire block, since the outsider may not be interested in a purchase of only a portion of the 100 shares. However, the corporation and remaining shareholders have a greater guarantee against stock transfers if they are permitted

to exercise their options in part, since they may then buy just enough of the stock to discourage the outsider, but they are not compelled to purchase all offered shares to prevent transfer. In the spirit of fairness, it is better practice to require the corporation to exercise its option in full or not at all. The restriction should further specify a procedure to prevent portion purchases, once the corporation has refused purchase and the offer is made to remaining shareholders, for the protection of the selling shareholder.

When more than one shareholder is entitled to an option to purchase, it is possible that some shareholders will exercise their options and others will not. In that case, a portion of the offered shares is available for sale to the outsider, but the outsider's interest in the purchase may dwindle after the number of shares has been reduced. To avoid this result, the restriction may provide that if all of the options are not exercised, none of them may be, which will preserve the block of stock intact. Alternatively, if the restriction permits some shareholders to refuse the option without impairing the rights of the other shareholders to exercise their options, it should further specify that the shares that have been refused will be offered to the shareholders who intend to exercise their options. These last shareholders have evidenced an interest in purchasing their quota of the offered stock; perhaps they will also purchase the remaining shares. This second chance for internal sale, which furthers the objectives of the remaining shareholders by granting another opportunity to avoid alienation of the shares, appears in the preceding example, "Option to Purchase Shares." Observe that if not all shares of the selling shareholder are purchased under the agreement, the amount paid by the corporation to the selling shareholder may be taxed as a dividend that is subject to ordinary income tax rates, while a complete redemption of all shares of the shareholder would be taxed at lower capital gain rates.¹³

In sum, the most fair and effective share transfer restriction first will grant the corporation the right to purchase all of the offered shares at a specified price; if the corporation refuses to buy all of the shares, then the other shareholders will have a right to purchase the offered shares according to their respective proportionate stock interests at a specified price; if some shareholders do not exercise their options, then none of them may, or the remaining unpurchased shares must be offered to the shareholders who have exercised their options before they may be sold to an outsider. All of these decisions should be made within a reasonably short time period so the shareholder and the outsider will have a prompt decision concerning whether the shares will be available for purchase by the outsider.

Mandatory Buyout or Sellout Provisions

The foregoing restrictions on transfer of shares are designed to avoid the alienation of shares and the potential loss of control of the corporation. Both goals are accomplished by granting the corporation or other shareholders the right of first refusal when shares are offered for sale. However, the shareholder may not be able to sell his or her shares to anybody (especially if the shareholder has invested in a small, closely held corporation), and then the shareholder deserves some protection. The shareholder agreement may require the corporation or the other shareholders to purchase the shares under certain circumstances. Conversely, the corporation may demand the right to purchase certain shares, such as when a shareholder-employee retires or quits. Thus, depending on the purpose to be served, mandatory buy or sell provisions may work both ways: the contract may require the corporation or other shareholders to purchase the shares, or it may require the shareholder to sell the shares.

Mandatory buyout agreements reflect an *obligation* on the part of the corporation and other shareholders to purchase the selling shareholder's stock, as distinguished from an option on their part to buy under the share transfer restriction. These mandatory provisions are designed to guarantee a market for the stock, which may be needed particularly by a minority shareholder. The minority shareholder cannot sell if no willing purchasers are available, and the minority shareholder is powerless to force dissolution to recoup invested capital if the majority shareholders resist. The majority shareholders also may need the guarantee. Willing purchasers may be difficult to find for a large block of stock, and while the majority shareholders can force dissolution, that may be an unwise business decision and may constitute oppression of the minority shareholders.

On the other hand, the mandatory buyout agreement also may impose the obligation on the part of the shareholder or the shareholder's representatives upon the occurrence of a triggering event to sell the shares to the corporation or to the other shareholders. The corporation and the other shareholders may thereby protect against the ownership of shares by persons who are strangers to the enterprise, such as the heirs of a deceased shareholder, a trustee in bankruptcy, or the representatives of a disabled shareholder.

Events Commonly Triggering Buyouts A mandatory buyout agreement is usually conditioned upon the death of a shareholder, the retirement of a shareholder at a certain age or after a specified length of service to the corporation, the disability of a shareholder, the bankruptcy of a shareholder, the loss of a shareholder's occupational license, or any attempt by a shareholder to force a dissolution of the corporation under statutory dissolution sections.¹⁴

The event triggering the buyout should be clearly defined; and if life insurance or other insurance is used to fund the buyout agreement, the definition of the contingent event should contain the same terms as the definition of that event under the insurance policies that are expected to fund the purchase. For example, if the disability of a shareholder will trigger a buyout, the agreement should define *disability* in the same method as the insurance policy defines the term, or the agreement should refer to the insurance policy definition. The agreement should further provide that after a specified period of time of continuous disability, again as defined in the insurance policy, a buyout will occur with the proceeds of the insurance policy.

Purchase on Death

EXAMPLE

The Company will have the option, for a period commencing with the death of any shareholder and ending 60 days following the qualification of his or her executor or administrator, to purchase all of the shares owned by the decedent, at the price and on the terms provided in this agreement. The option shall be exercised by giving notice to the decedent's estate or other successor in interest in accordance with this agreement. If the option is not exercised within such 60-day period as to all shares owned by the decedent, the surviving shareholders shall have the option, for a period of 30 days commencing with the end of that 60-day period, to purchase all of the shares owned by the decedent, at the price and on the terms provided in this agreement. The option shall be exercised by giving notice, in accordance with this agreement, to the executor or administrator, stating the number of shares as to which it is exercised. If notice of exercise from the surviving shareholders specify in the aggregate more shares than are available for purchase by the shareholders, each shareholder shall have priority, up to the number of shares specified in his or her notice, to such proportion of those available shares as the number of Company shares he or she holds bears to the number of the Company shares held by all shareholders electing to purchase. The shares not purchased on such a priority basis shall be allocated in one or more successive allocations to those shareholders electing to purchase more than the number of shares to which they have a priority right, up to the number of shares specified in their respective notices, in the proportion that the number of shares held by each of them bears to the number of shares held by all of them. In the event this option is not exercised as to all of the shares owned by the decedent, his or her estate will hold those shares subject to the provisions of this agreement.

Purchase on Other Events

EXAMPLE

In the event any shareholder is adjudicated a bankrupt (voluntary or involuntary), or makes an assignment for the benefit of his or her creditors, or is physically or mentally incapacitated for more than three months, the event of incapacity as described in an insurance policy now owned by the corporation with the Equitable Life Insurance Corporation, Policy No. 40-82-123, the Company and the remaining shareholders shall have the option for a period of 90 days following notice of any such event to purchase all of the shares owned by the shareholder. Notice shall be given to the shareholder or his or her representative in accordance with this agreement. The option shall be exercisable first by the Company and thereafter by the remaining shareholders, and the price, terms of purchase, and methods of exercise of the option shall be the same as are provided in this agreement to apply in the event of death. In the event this option is not exercised as to all of the shares owned by the shareholder, he or she or his or her successor in interest will own the shares subject to the provisions of this agreement.

The compelling reasons for these types of agreements are easy to appreciate. The shares of a close corporation are not generally marketable, and the beneficiaries or legatees of a deceased shareholder or the representatives of a disabled shareholder usually are not interested in holding shares in the business the shareholder enjoyed while the shareholder was productive in the business. Moreover, as an employee, the shareholder was probably receiving a salary instead of dividends, and dividends are rare in a small corporation anyway. Consequently, if the stock is not readily marketable, the salary is terminated, and there are no dividends or other benefits of share ownership, the beneficiaries or representatives of the shareholder will receive nothing from the share ownership, unless the corporation and the other shareholders are required to purchase the shares.

Mandatory sellout agreements are frequently used with employment contracts, the terms of which contemplate issuance of shares as an incentive to performance. If the employee was misjudged and is subsequently terminated, the corporation has the right to buy back the shares. The agreement also may be separately executed to prevent continued stock ownership by any person for whatever reason. The shareholder is required to sell the shares to the corporation or to the other shareholders if they insist on the sale, with appropriate notice. The price is usually established in the agreement, as discussed in detail later, and provisions for surrender of shares should be included.

EXAMPLE

Common Stock of One Leaving Employ of Corporation May Be Purchased

In the event that any holder of the common stock of this corporation who may now or hereafter be an officer or employee of this corporation ceases, for any reason, to be such officer or employee, and provided further that the Board of Directors shall require it, by resolution passed at a special meeting called for that express purpose on not less than 2 days' notice, the corporation or any officer or any common stockholder subscribing to this agreement shall have the option, within 30 days after such person shall cease to be an officer or employee, to purchase all of the common stock held by such person ceasing to be an officer or employee, at a price to be determined by the same method as hereinabove provided, and the tender of the amount of such purchase price shall operate to transfer and vest said shares of common stock in the corporation or officer or stockholder making such tender, and the common stockholder who has thus ceased to be an officer or employee shall, upon such payment or tender, transfer, assign, and set over his or her common stock to the officer or common stockholder exercising such option.

Considerations in Designating the Mandatory Purchase Requirement The agreement should bind the corporation and the other shareholders to the purchase. However, the corporation's ability to purchase shares, even though required by the agreement, is limited by most state statutes, and the corporation may not have funds legally available for the purchase. In that event, the agreement should obligate the other shareholders to purchase their proportionate share of the stock, or to vote in favor of dissolution of the corporation. The latter provision anticipates the possibility that the individual shareholders will not be able to afford the purchase.

If the other shareholders are to buy the shares under the agreement, a procedure should be specified to proportion the shares they are permitted to purchase among them in the same ratio as their existing share ownership. (See the earlier example "Purchase on Death.")

Forced Buyout Provisions

In many closely held corporations, partnerships, and limited liability companies, the owners seek to provide for a "back door" through which they can exit the business, even if another triggering event for a buyout has not occurred. If none of the owners has received a bona fide offer and they are all well, alive, and solvent, the equity owner of the company is trapped in the business. He or she may yearn for a fishing trip in the Rockies or may want to make a career change to further his or her professional endeavors, but there is no way out of the owner-

ship of the business unless an agreement has anticipated this situation. On the dark side, the owners may have lost their compatibility and realize they can no longer work together; their adventure, and perhaps their relationship, may have lost the luster. The only manner in which they can salvage the value of the business may be to sever their relationship—but it may be the case that none of them wants to leave, and each believes that he or she is the most capable of advancing the business. In such cases, the agreement may provide a **forced buyout** procedure, a mechanism designed to require that the other owners purchase or sell the ownership interest at a fair price.

The forced buyout is usually found in a corporation with only two shareholders. It is most useful when the shareholders have elected equal ownership because each is an equal contributor to the business. Such shareholders are typically people who would have selected a partnership for the organization, but have formed a corporation because of its limited liability features. When two shareholders each own fifty percent of the outstanding stock, the possibility of deadlock is obvious and the likelihood of discord is predictable. Usually both shareholders are directors (of a two-person board) and both serve in important officer positions. A dissenting vote of one cancels the affirmative vote of the other. An agreement can provide a mechanism to resolve the dilemma of equal ownership when the owners of the entity cannot agree.

The commonly used forced buyout provisions have earned legendary names. The procedure by which the funds of the corporation are used to purchase the shares of one of the owners at the lowest possible cost is called a **“Jeopardy Auction,”** or a **“Wheel of Fortune.”** The procedure by which one shareholder is forced to either buy or sell shares in a corporation is called the **“Deadwood Draw.”** The names are descriptive of the process used in an agreement to permit any owner to elect to eliminate the other or to exit the business by engaging in certain agreed procedural steps to force the purchase or sale of shares.

The Auction The Jeopardy Auction, or the Wheel of Fortune, involves an election by one of the owners to require the corporation to purchase shares from a shareholder. The shareholders must agree to these terms, and the corporation must be a party to this agreement. The agreement must be adopted by the board of directors on the corporation’s behalf. Thus, the agreement must be drafted and approved during the time when the shareholders (who usually are also the directors) are congenial and committed. This agreement requires the purchase of shares by the corporation with corporate funds and avoids the need for any shareholder to use personal funds to buy out the other shareholder. Because the corporation is purchasing the shares of any of its shareholders willing to sell at the lowest price, this agreement also may be used for corporations with multiple shareholders, unlike the Deadwood Draw agreement that is most useful with two relatively equal shareholders. However, as in the Deadwood Draw, the shareholder initiating the Jeopardy Auction procedure is subject to a risk that he or she may be forced to sell the shares and leave the company or may become the owner of a company struggling with an inadequate cash position while satisfying the terms of an expensive buyout of the other shareholders.

The Jeopardy Auction, or Wheel of Fortune, provisions begin with clauses permitting a shareholder to initiate a buy-sell procedure by giving written notice to the corporation that requires the corporation to solicit offers from all shareholders according to certain described terms. The procedure usually requires that each shareholder must offer to sell all of the shares owned by him or her, and provides certain boundaries for the transaction (such as the method by which the price will be paid or the basis upon which the payment of the price will be secured). Because the corporation is subject to statutory limitations on the repurchase of shares, the agreement must anticipate that the corporation may not meet the statutory criteria to purchase the shares. In addition, it is prudent to set limits on the use of the corporation’s liquid assets for this purpose, since the corporation will continue to function with its normal business obligations while completing this transaction. In such cases, the agreement should require that if the corporation cannot satisfy the stated or statutory conditions, the shareholders will be obligated to purchase the shares or to contribute additional capital to permit the corporation to complete the purchase.

EXAMPLE**Initiation**

If, during the term of this Agreement, either Smith, on the one hand, or Jones, on the other hand (“Initiator”), wishes to initiate a buy-sell procedure, he or she will do so by giving written notice (“Initiating Notice”) to the Corporation and to the Remaining Shareholders. The Initiating Notice shall state the terms under which the buy-sell procedure shall be conducted, within the following limitations:

- (1) The price for the Shares purchased shall be paid in cash or certified funds within ninety (90) days following the Acceptance;
- (2) The Offer must offer all Shares owned by Smith, on the one hand, and Jones, on the other hand; and
- (3) If the Corporation does not have legally available funds for the purchase of Shares in the buy-sell procedure, or if more than one-half of the Corporation’s cash on hand as of the date of the Closing is required to pay the purchase price, each Shareholder must commit to purchase individually the Shares sold through the buy-sell procedure or to contribute to the Corporation any capital or cash (in addition to one-half of the Corporation’s cash on hand at the Closing) necessary to purchase the Shares as in the event that such Shareholder retains his or her Shares following the buy-sell procedure.

Upon receipt of the notice initiating the procedure, the corporation solicits the shareholders to submit an offer to the corporation to sell their shares according to the terms in the solicitation. The solicitation states any restrictive terms required by the agreement (such as the fact that the offer must include all shares owned by a shareholder or that the selling shareholder must offer to commit to a covenant not to compete with the company for a period of time) and describes a procedure for the response (such as the submission of offers in sealed envelopes within a certain period of time). Similarly, any affirmative requirements for the sale (such as warranties against encumbrances or liens on the shares or resignations from officer and director positions) are described. There is always a possibility that one or more of the shareholders will not tender an offer as required by the solicitation, especially if the shareholders are not cooperating with each other and that is the catalyst for the use of the buyout procedure. The agreement must provide some penalty for failure to submit, such as providing that the shareholder so failing is deemed to have made the lowest offer and is thus subject to elimination by default.

EXAMPLE**Solicitation**

The Corporation shall, within a period of three (3) days after the Corporation’s receipt of the Initiating Notice, give a written solicitation (“Solicitation”), stating the terms described in the Initiating Notice, to Smith and Jones to submit to the Corporation an offer to sell his or her Shares according to the terms stated in the Solicitation.

EXAMPLE**Offers**

Smith and Jones shall submit offers to sell his or her Shares (“Offer”) to the Corporation in writing within ten (10) days after the date of the Solicitation. The Offer shall state the price upon which Smith and Jones, as the case may be, are willing to sell his or her Shares upon the terms stated in the Solicitation; shall contain a representation that the Offer is authorized by all necessary action on behalf of the Shareholder and that the Shares are free of any liens, encumbrances, or claims of any person; shall contain a written agreement to sell such Shares at the price stated in the Offer; shall contain the commitment by the Shareholders to purchase or contribute additional capital as required by this agreement; shall contain the resignations from all corporate offices held by the individuals represented by the Shareholders making the Offer; and shall be signed by all persons claiming an interest in the Shares. The failure to submit a timely, complete, and correct written Offer shall be deemed to be an offer to sell Shares owned by the person or entity failing to so submit an Offer at book value as of the date of the Solicitation.

The corporation is required to accept the lowest offer submitted by the shareholders, and thus is purchasing the shares at the lowest possible price. If the process works, the shareholders who desire to remain with the business will submit high bids for their shares, and the shareholders with other objectives will bid low. If some shareholders want to get rid of another shareholder, they will inflate their offers (to be sure their offers are not the lowest), allowing the departing shareholder to request and receive a wide range of possible values, some of which may be substantially higher than fair market value. On the other hand, if a shareholder wants to leave for other pursuits, he or she will submit a bid at the lowest amount that will allow an acceptable return of some of the investment, even if it is substantially below the actual value of the shares. The agreement should provide a procedure for the corporation to accept the lowest offer, and describe the position of the shareholder owning the shares to be purchased after the acceptance occurs.

Acceptance

The Corporation shall accept in writing the Offer containing the lowest price (“Acceptance”) within three (3) days after receipt of the Offers, and shall notify the Shareholders in writing of the Acceptance. Following the Acceptance, the Shareholder whose Shares are being purchased (the “Selling Shareholder”) shall be entitled only to payment of the purchase price according to the terms stated in the Offer and Acceptance, and shall not thereafter be entitled to any rights as a Shareholder, except to enforce the agreement to purchase the Shares as provided in this agreement.

EXAMPLE

After acceptance, the selling shareholder should only be entitled to receive the payment for the shares and should exercise no other shareholder rights. At this point, the shareholder is an outsider and is not likely to exercise his or her judgment in the best interests of the corporation. Thereafter, a closing of the transaction should occur. If the closing is not contemporaneous with the acceptance of the offer, the agreement must anticipate what will happen if the closing does not occur, since in the intervening period, the other shareholders may have adopted corporate action that is adverse to the interests or inclination of the departing shareholder, and if the shares are not purchased, the selling shareholder may still own an interest in a company that is traveling in the wrong direction, at least as far as that shareholder is concerned. It is typical to provide for a period of limbo between the acceptance and closing during which no corporate policies may be changed, or to require that all corporate action taken during that period is rescinded if the closing does not occur.

Closing

The agreement contemplated hereunder shall be closed and completely performed within ninety (90) days following the Acceptance. In the event that the agreement is not so closed, the Selling Shareholder shall be restored to the status of a Shareholder of the Corporation, all Corporation action taken during the ninety (90) day period pending the Closing shall be rescinded, and the Selling Shareholder shall retain an action against the Corporation for damages for breach of the agreement.

EXAMPLE

The Deadwood Draw As the name implies, this forced buyout provision contemplates a shoot-out at high noon (or any other time a shareholder decides to get out of the company). These provisions are most effective with equal or nearly equal shareholders who have similar financial abilities. If one shareholder owns a substantially greater number of shares than the other, or if one shareholder has substantially greater financial resources than the other, the lack of balance may produce oppressive and unwanted results from the Deadwood Draw provisions.

The process is simple. If one shareholder decides to leave or decides that the other shareholder has to go, a notice is served on the other shareholder that the buyout process is being

initiated. The notice includes an offer to sell or buy shares of the corporation at a price and on certain terms and conditions. The shareholder receiving the notice may then elect, during the period specified in the offer or in the agreement, to either buy all the shares owned by the offering shareholder or sell all the shares owned by the responding shareholder to the offering shareholder. In the end, one of the shareholders will sell and the other shareholder will buy. Since each shareholder is likely to protect his or her own interests, the price and terms stated in the offer are likely to be fair. The offering shareholder does not want to risk having to sell his or her shares at a price below their actual value, so he or she will offer to buy the other shareholder's shares at a price that may be higher than their actual value. The other shareholder does not want to sell his or her shares below their actual value, so he or she will accept any offer that states a lower-than-actual price. Either way, the shareholder who wants to stay will buy at a price he or she is willing to pay, and the shareholder who wants to go will sell at a price he or she is willing to accept.

The agreement should provide for an initiation procedure and describe the requirements and conditions of the offer.

EXAMPLE

Initiation

If, during the term of this Agreement, either Smith, on the one hand, or Jones, on the other hand (the "Offering Shareholder"), desires to initiate a buy-sell procedure, he or she will do so by giving written notice (the "Offer") to the Corporation and to the Remaining Shareholder. The Offer shall specify the purchase price and the terms and conditions of sale, and shall constitute an offer to sell the Shares to the other Shareholder (the "Offeree Shareholder"). The Offer shall be subject to the following limitations:

- (1) The price for the Shares purchased shall be paid in cash or certified funds within ninety (90) days following the acceptance; and
- (2) The Offer must offer all Shares owned by the Offering Shareholder.

Once the offer is served, the receiving shareholder will have the option to purchase or sell. A period of time for this decision should be stated. If the receiving shareholder does not respond, a default provision should be included, preferably with a penalty for silence. The closing procedures and conditions also should be described.

EXAMPLE

Right to Purchase or Sell

For thirty (30) days after the receipt of the Offer, the Offeree Shareholder shall either:

- (1) Purchase all of the shares owned by the Offering Shareholder on the terms and conditions as specified in the Offer; or
- (2) Sell all of the Offeree Shareholder's Shares to the Offering Shareholder on the same terms and conditions as specified in the Offer.

The Offeree Shareholder must give notice of his or her choice of the options under this section within thirty (30) days following the receipt of the Offer from the Offering Shareholder. Failure to give notice of the choice shall be considered as an agreement by the Offeree Shareholder to purchase the Shares pursuant to Paragraph (1) above. A closing shall be held within thirty (30) days following the expiration of said thirty-day period or such earlier date as the parties shall agree.

At the closing, the selling Shareholder shall deliver a certificate for the shares, duly endorsed, and shall warrant the selling Shareholder has marketable title to the shares, free and clear of all encumbrances, and shall deliver all documents necessary to effectuate the transfer thereof. The purchasing Shareholder shall deliver the payment as required.

In the event that the Offeree Shareholder has elected to sell all of his or her shares to the Offering Shareholder pursuant to the provisions of Paragraph (2) above, and the Offering Shareholder thereafter fails to purchase the Offeree's Shareholder's shares, the Offeree Shareholder shall have, for a period of ten business days after the passing of the closing date, the right to purchase the Offering Shareholder's shares at a price determined by calculating the book value of the Corporation's assets as of the last day of the preceding fiscal year. The book value of the Corporation shall be determined by a certified public accountant retained by the Corporation for this purpose, determined in accordance with generally accepted accounting principles.

Mechanics of the Agreement

Notice Procedure The agreement should always establish a notice procedure to advise the corporation and the other shareholders of the intended sale (in the case of the stock transfer restriction) or to advise the persons holding the shares of a shareholder subject to a mandatory buyout agreement that the option to purchase is being exercised. This notice procedure should further state a time period for a decision to purchase or refuse and for surrender of the shares.

Notice of Sale

EXAMPLE

The shareholder shall notify the directors of a desire to sell or transfer by notice in writing, which notice shall contain the price at which the shareholder is willing to sell. The directors shall within thirty days thereafter either accept or reject the offer by notice to the shareholder in writing. After the acceptance of the offer, the directors shall have thirty days within which to purchase the same at such valuation, but if at the expiration of thirty days, the corporation shall not have exercised the right to so purchase, the owner of the stock shall be at liberty to dispose of the same in any manner he or she may see fit.

Notice to Purchase

EXAMPLE

The Company shall have the option, for a period commencing with the death of any shareholder and ending 30 days following the death of the shareholder, to purchase any part of the shares owned by the decedent, at the price and on the terms provided in this agreement. The option shall be exercised by giving notice of it to the decedent's estate or other successor in interest in writing. Such notice shall be deemed to have been duly given on the date of service if served personally on the party to whom notice is to be given, or within 72 hours after mailing if mailed to the party to whom notice is to be given by first class mail, registered or certified, postage prepaid and properly addressed to the party at his or her address set forth on the signature page of this agreement, or any other address that that party may designate by written notice to the other parties of this agreement.

Price Provisions Any shareholder agreement involving the purchase and sale of stock must specify the price and payment terms applicable to the transaction. Restrictions on share transfer that require the offer of shares to the corporation and/or the remaining shareholders must establish a price for the offer. Similarly, mandatory buyout or sellout agreements must specify the price to be paid.

Competing interests frequently arise in the negotiation of the price term. The shareholder would usually prefer to receive the highest price in cash as soon as possible, while the purchaser would usually prefer to pay the lowest price over the longest period of time. Many practical considerations also arise. For one thing, extended payment provisions always involve some risk for the selling shareholder, since the purchaser may become insolvent, may be unable to pay for another reason, or may simply refuse to pay. However, immediate payment in cash may be unrealistic, depending upon the number of shares involved and the cash position of the purchaser.

The price provisions of the buyout or restrictive agreement may accomplish several objectives. Depending upon the clients' desires, the following questions should be considered.

1. What price will estimate most accurately the value of the stock in case of a buyout or sellout?
2. What price term will reflect most permanently the formula necessary to value the stock accurately?
3. What assets will be used to fund the stock purchase, and if insurance proceeds are anticipated, will the price vary from the availability of the proceeds, and if so, in what manner?
4. Is there a desire to use the price provision as a further restriction upon the transfer of the shares?
5. Will the price provision be so unrealistic that the entire agreement will be unenforceable?

To be fair, the price provision of the stock purchase agreement should attempt to accurately reflect the true value of the stock at the time of purchase. Even if the parties intend to use the price provision as an additional restriction on the stock, so that no shareholder will be motivated to attempt to sell the stock because the price at which it must be sold under the stock transfer restriction would be prohibitive, it should be noted that courts are reluctant to enforce a stock transfer restriction that contains an unrealistically low price for the transfer of the stock. The effect of such price provisions are to prohibit the sale of the stock, since no shareholder would attempt to locate a buyer if it were necessary to sell the stock to other shareholders or to the corporation at an unrealistically low price.

There are several ways to prescribe the price and method of payment for stock purchase agreements. These terms are always subject to negotiation by the parties. Moreover, counsel who represents the corporation may not be able to represent ethically the interests of the individual shareholders who are intended to be parties to the agreement. Each shareholder has an individual interest in maximizing the amount to be paid for his or her shares and minimizing the amount to be paid for any of the other shareholders' shares. The corporation has an interest in paying a fair value for the shares. These conflicting interests place the lawyer and paralegal in an ethical conflict if they attempt to accomplish the interests of all parties. Accordingly, corporate counsel should recommend that individual shareholders obtain their own legal counsel to review and advise them concerning the agreement.

Firm Price The agreement may establish a **firm price** to be paid for shares, such as fifty dollars a share, which will be applied to any purchase of stock for the duration of the agreement. This practice should be discouraged except in extremely short-term agreements or at the early stages of the corporation (when the price is difficult to establish from other sources). It is probable that the stated price will become unrealistic one way or the other over an extended period of time.

EXAMPLE

Firm Price

The price at which the shares are to be offered to the corporation or to the remaining shareholders shall be \$2.00 per share for the first year of this agreement.

Adjusted Stated Value The agreement may provide for a **stated value** with a procedure for periodic adjustment. This method allows modifications in price to account for changed circumstances over an extended period of time. Usually a stated price will be coupled with a further agreement that the shareholders of the corporation will evaluate and reset the stated value on a periodic basis. As in any situation where people are negotiating a price, it is possible that the shareholders will not be able to agree on the adjustment. Therefore, the provision should include a certain formula to compute the adjustment to stated value in case the parties cannot agree upon an adjustment to the price. For example, in the absence of shareholder agreement, the stated value may be increased or decreased by a percentage of the net income or loss, or a reevaluation of the assets. Alternatively, arbitration or another dispute resolution technique may be used to resolve issues that prevent an agreement on the price of the shares.

EXAMPLE

Agreed Price with Arbitration

The purchase price to be paid for each of the shares subject to this agreement shall be equal to the agreed value of the Company divided by the total number of shares outstanding as of the date of the price to be determined. The initial agreed value of the Company is \$185,000, and on January 20 of each year hereafter, the parties to this agreement shall review the Company's financial condition as of the end of the preceding fiscal year and shall determine by mutual agreement the Company's fair market value, which, if agreed upon, shall be the Company's value until a different value is agreed on or otherwise established

EXAMPLE

under the provisions of this agreement. If the parties are able to reach mutual agreement, they shall evidence it by placing their written and executed agreement in the minute book of the Company.

If no valuation has been agreed upon within two years before the date of the event requiring determination of value, the value of a selling shareholder's interest shall be agreed upon by the selling shareholder or that shareholder's successor in interest and the remaining shareholders. If they do not mutually agree on a value within 60 days after the date of the event requiring the determination, the value of the selling shareholder's interest shall be determined by arbitration as follows: The remaining shareholders and the selling shareholder or that shareholder's successor in interest shall each name an arbitrator. If the two arbitrators cannot agree on a value, they shall appoint a third, and the decision of the majority shall be binding on all parties. Arbitration shall be in accordance with the rules of the American Arbitration Association that are in effect at the time of arbitration.

Earnings Multiple Formula A preferred method of determining the price of the stock is to specify a formula that will account for the success of the business, the value of the assets, and the desirability of the stock if a market existed for its sale. A common formula for evaluation of stock is a **multiple of earnings formula**.

An earnings multiple formula establishes the price of corporate stock by multiplying the earnings of the corporation by a stated figure, which is set when the agreement is negotiated. The multiplier may fluctuate in the agreement, depending upon the number of years the shares have been held, or upon the number of shares held. For example, a multiplier of 3 times earnings may apply to blocks of 100 shares or less, held less than 2 years; a multiplier of 4 times earnings may apply for blocks of 100 to 200 shares held more than 2 years; and so forth. The definition of *earnings* deserves attention in the agreement, which should specify whether earnings refers to net earnings before or after tax, and whether the earnings will be determined by an average of several years' earnings or a current income figure.

The earnings multiple formula probably has no relation to the actual market value of the stock, if one exists, or to the book value of the stock. It simply ensures that if the corporation has increased its earnings during the agreed period, the shareholder who desires to sell stock will realize some benefit from that increase. On the other hand, if earnings have decreased, the shareholder will have suffered by waiting to sell shares. In the event the corporation loses money and the earnings multiple produces a negative figure, the agreement may contain a **savings provision** that in no event will the stock be valued at any less than a stated amount. Such a provision ensures that the stock will always have some minimum value, and is obviously a desirable provision from the shareholder's standpoint.

The provisions that establish the earnings multiple formula should identify the person who will determine earnings conclusively from a specified source. The company's accountant, who has prepared the financial statements under generally accepted accounting principles, is often specified as the person who will determine and compute earnings as of the date of the buyout agreement. Moreover, it may be necessary, in small, closely held corporations, to specify certain adjustments to earnings that will more accurately reflect the true earnings of the corporation for the period averaged. In closely held corporations, it is common to pay shareholder-employees salaries that may be higher than those normally paid for similar employees. It is also common to provide for greater-than-normal lease payments for shareholder-owned equipment, and greater-than-normal interest payments for shareholder loans. These expense figures should be addressed and adjusted in the earnings formula computation in order to reflect more accurately the true value of the stock based upon earnings.

The determination of an earnings multiple is frequently a negotiated matter, and ultimately depends upon a reasonable rate of return in the industry. Rates of return for certain industries are published from time to time by economic marketing sources and business brokers, and they may be used as a guide in determining the appropriate rate of return to set the multiple for earnings. The shareholders themselves are frequently capable of estimating a reasonable rate of return, which, if agreed to, may be used as the multiple in the earnings formula.

EXAMPLE**Capitalized Earnings Formula**

The purchase price to be paid for each of the shares subject to this agreement shall be determined as follows:

The net profits of the Company for each of the three complete fiscal years preceding the date of determination of price for purposes of this agreement shall be adjusted by deducting from the Company's profits state and federal income taxes, lease payments to shareholders, salary payments to shareholders, and interest payments on loans from shareholders. The net profit figures for the three years, thus adjusted, shall be added, and the total shall be divided by three. The average adjusted net profit figure so obtained shall be multiplied by 10, and the result shall be divided by the number of shares of the Company's capital stock then outstanding.

Book Value Formula A book value formula may be a more accurate estimate of the actual value of the shares, depending upon the definition of book value and the nature of the business. Usually book value is determined by dividing the net assets (total assets less total liabilities) by the number of the outstanding shares of the corporation. This means that each shareholder is entitled to a proportionate share of the assets, and the purchase price of the shares will be an amount equal to this proportionate interest. The purchase price will increase as net assets increase, and vice versa. The accuracy of the formula is affected by the nature of the business. A highly profitable organization may operate with few assets, in which case the book value will be considerably lower than the fair market value of the shares. Conversely, it may be possible for a business with many assets to have high book value for shares that are virtually worthless. For example, a highly profitable real estate brokerage may have only a few assets, such as some desks, computers, and telephones, but the income earned by the company makes its shares very valuable. If only the value of the assets are used to determine the value of the shares, the price will be too low. On the other hand, a manufacturing facility that makes an obsolete product has machines and equipment with a high book value, but the fact that the product cannot be sold makes the business valueless. In this case, a book value formula will overstate the value of the shares.

The book value should be determined by a specified person, and the clause containing the book value formula should provide some guidance for the computation of book value. Again, if an independent accountant is used to prepare the corporate balance sheets in accordance with generally accepted accounting principles, that person may make the sole determination of the book value at a specified time. In addition, if certain assets are undervalued on the balance sheet, such as real estate that has appreciated considerably from the time it was purchased, or if liabilities are overstated, such as contingent liabilities that are not likely to be realized by the corporation, the book value formula should direct the accountant to adjust those figures to reflect more accurately the true value or liability.

To minimize the cost of a determination of book value at any point in time, it is advisable to provide that book value will be determined as of the date of the last financial statement prepared before the occurrence of a contingent event. The financial statements are prepared on a regular basis, and it is much less expensive for the corporation to use a regular financial statement than to prepare a new balance sheet only for the purpose of estimating the value of the stock for the contingent event that has triggered a buyout. It may be provided that the values contained on the last financial statement should be adjusted, upward or downward, to reflect material changes in current operations.

Since book value includes all the assets of the corporation, care must be taken not to include the proceeds of insurance that may be payable to the corporation and were intended to be used to purchase the shares under the shareholder agreement. For example, if the corporation is expecting to use proceeds of life insurance to fund a buyout in case of a shareholder's death, the proceeds should be specifically excluded from a determination of book value, since the corporation will be entitled to them upon the death of the shareholder, and they will increase the corporation's net assets.

Book Value

The purchase price to be paid for the shares subject to this agreement shall be their book value determined as of the most recent financial statement prepared by the Company's accountants with additions or subtractions for current operations up to the end of the month preceding the month in which the event requiring determination of the purchase price occurs. Book value shall be determined from the books of the Company according to generally accepted principles of cash accounting applied in a consistent manner by the accountants of the Company who customarily prepare the Company's financial statements. The Company's book value shall be equal to its assets, excluding any proceeds of insurance policies, less its liabilities, and the amount thus determined shall be divided by all shares of the Company's capital stock then outstanding.

EXAMPLE

Combination of Formulas Since earnings multiple and book value formulas rarely reflect the true market value of the stock, it may be appropriate to combine these formulas with others to estimate accurately the true value of the stock at the time of the purchase.

Formula to Determine Value (Book Value with Earnings)

If any holder of any shares of the common stock of this Corporation desires to dispose of the same or any part thereof, that shareholder shall not transfer or otherwise dispose of the same to any person unless and until he or she has first complied with the provisions hereof and given the other common stockholders of the Corporation who are entitled to the benefits of this contract an opportunity to purchase the same, as herein provided. The common stockholder desiring to dispose of all or any of his or her stock shall give written notice of such desire to each of the officers of this Corporation within the State of Montana, stating the number of shares he or she desires to sell. Any officer or any other common stockholder of the Corporation entitled to the benefits of this contract may, within thirty days after the service of such notice upon the last officer to be served, elect to purchase any part or all of the common stock so offered, and in the event of the exercise of such option, the common stockholder so giving such notice of a desire to sell shall forthwith sell, assign, transfer, and set over said shares of common stock to the officer or common stockholder electing to purchase the same, and the officer or common stockholder to whom the shares are so transferred shall, at the same time, pay to the seller, as and for the purchase price thereof, the amount of the book value of said common stock as shown upon the last annual statement of the Corporation, and in addition thereto an amount equal to the stock's pro rata proportion of the net profits of the business of the Corporation for such fractional part of the fiscal year as has elapsed since the date as of which the last annual statement was made, less any dividends declared during said fractional period.

For the purpose of determining said profits, the amount of the average annual net profits of the Corporation for the two fiscal years preceding the last annual statement shall be assumed to be the amount of the net profits the Corporation shall earn during the current fiscal year, and the amount of the net profits of the Corporation for the fractional period of the year since the last annual statement shall be considered as that proportion of the average annual net profits of said two preceding years as the length of time which has lapsed since the last annual statement bears to the period of a full year. For the purposes of this contract, until the first annual statement of the Corporation is made, the book value shall be determined on the figures at which this Corporation has purchased the business and property of Everready Associates, a copartnership, and until this Corporation has completed two fiscal years which may be used as a basis for determining the average annual net profits, as aforesaid, the net earnings of the Corporation, for the purpose of this contract, shall be determined from the average net earnings during the preceding two fiscal years of the operation of said business either by this Corporation or by the copartnership from which its business was acquired, and for that purpose, reference shall be had to the books of said copartnership for a sufficient period prior to the organization of this Corporation to produce a two-year average. If it shall be necessary to use the net profits of the copartnership as a basis, proper adjustment and allowance shall be made for the fact that no salaries were paid by said copartnership, and that part of the capital of the Corporation is preferred stock. For the purposes of this contract, the annual statements of the Corporation shall be made up on the same plan and method as has heretofore been followed by said copartnership.

EXAMPLE

Several other formulas may be used for determining the value of the shares, but they are mostly a product of the imagination of the drafter. Any formula that will establish a value for the shares and will serve the purposes of the agreement may be used. Note that the choice of the formula may significantly assist the effect of share transfer restrictions. If a share transfer restriction requires that all shares must be offered to the corporation at book value, and the book value considerably understates market price, the shareholder will be less likely to attempt to sell shares because the shareholder risks having to accept the book value price in any case. This provision does not run afoul of the rule that a complete restriction on sale is prohibited, since the shareholder does have the right to sell the stock. However, as a practical matter the shareholder is not likely to do so.

Matching a Bona Fide Offer If a shareholder intends to sell stock and is subject to a share transfer restriction, the agreement may specify, in lieu of an agreed value, adjustable agreed value, or formula evaluation of price, that the corporation will be obliged to pay a price equal to that offered to the shareholder by the outsider investor. The selling shareholder benefits from this price determination, since the shares will be purchased by the corporation at exactly the same price as would have been received from the outsider. A **matching price provision** should be used only when the agreement also requires, as is usually the case, that the shareholder must have received a good faith offer from an outsider that is definite and provable to the corporation's satisfaction.

If one objective of the agreement is to discourage the transfer of shares to outsiders, the matching price provision is not the best alternative, because it ensures that the shareholder will receive the same consideration no matter who purchases the shares. Transfer is best discouraged by a clause giving the corporation or other shareholders the option to match the price, or to purchase at some other price, stated or determined by formula, whichever is lower.

EXAMPLE

Matching Offer

The price at which the shares are to be offered to the corporation or to the remaining shareholders shall be equal to the bona fide offer received from the offeror, or equal to book value as determined by the provisions of this agreement, whichever is lower.

Appraisal An **appraisal** at the time of purchase may provide the most accurate but also the most expensive determination of value. The person who is to make the appraisal should be named in the agreement, or a procedure for naming appraisers should be described. For example, the agreement can name a mutually agreeable appraiser or can provide for the selection of a panel of appraisers who will determine the value of the stock.

The clause providing for an appraiser should specify the appraiser's qualifications, which should indicate some familiarity with the particular industry in which the corporation conducts its business. The clause should provide for the method of payment of the appraiser's expenses, and it is fair to provide that these expenses will be paid by the corporation (thereby absorbing the cost of the appraisal among all shareholders). Note that if the corporation is paying the appraiser, however, the appraiser's independence in determining the actual market value of the stock may be impaired.

The method of appraisal should be specified, since business appraisers use various methods to determine the value of a business. A liquidation value may be unrealistic, since it would include only the value of the assets, less the payment of the liabilities, if the assets were immediately sold for a price. A preferable method is an appraisal based upon **going-concern value**, which should include consideration of goodwill, business reputation, expected useful life of the assets, and liquidity of the company (its cash and current asset position projected over a period of time considering potential expenses and liabilities). Most business appraisers apply a discount to the value of minority shares, since minority shareholders are rarely able to affect corporate policies. This potential discount for minority interests should be considered in

the agreement; if a discount of shares simply because they represent a minority position is not desirable, the discount should be excluded in the instructions to the appraiser.

Appraisal

EXAMPLE

The purchase price to be paid for each of the shares subject to this agreement shall be determined by appraisal. Within ten days after the occurrence of the event requiring the determination of the purchase price under this agreement, the Company shall cause Levine & Company, independent appraisers, to appraise the Company and determine its value. The appraisal fee shall be paid by the Company. In making the appraisal, the appraisers shall value real estate and improvements at fair market value; machinery and equipment shall be valued at replacement costs or fair market value, whichever is lower; finished inventory shall be valued at cost or market, whichever is lower; goods in process shall be valued at cost, using cost accounting procedures customarily employed by the Company in preparing financial statements; receivables shall be valued at their face amount, less an allowance for uncollectable receivables that is reasonable in view of the past experience of the Company and the recent review of their collectability; all liabilities shall be deducted at their face value, and a reserve for contingent liabilities shall be established, if appropriate in the sole discretion of the appraiser. The value of other comparable companies, if known, shall also be considered. The value determined by appraisal shall be divided by the total number of shares of the Company's capital stock then outstanding. No discount shall be applied for the fact that the shares to be purchased under this agreement shall constitute less than 50% of the total shares then outstanding.

The appraisal provisions may be combined with other evaluation methods. The following clause uses a shareholder determination of stated value, but appraisal is used if the determination of the shareholders is not current.

Agreed Value or Appraisal to Determine Price

EXAMPLE

For the purposes of this agreement, each share of said stock shall be regarded as having a value of One hundred dollars (\$100). The value of said stock as above determined may be changed from time to time by an endorsement over the signatures of the stockholders in the appendix to this agreement. A determination of value, whether made in this clause or in the appendix, shall remain vital and controlling for the period of one year from its effective date unless within such period it is superseded by a new determination. Should the death of a stockholder occur after one year from the effective date of the last determination of value, the value at the date of death shall be determined by three appraisers, one to be appointed by the surviving stockholder(s), one by the decedent's estate, and one by the two appraisers appointed as first provided. In their process of appraisal, the appraisers shall assume that the last valuation made by the stockholders, whether in this clause or in this appendix, was true and correct as of the date it was made, and with that assumption as a point of beginning, they shall proceed to redetermine such value with reference to the relevant facts and circumstances existing at the time of the decedent's death. Notwithstanding this provision for appraisal, the surviving stockholder(s) and the decedent's estate may elect to accept as controlling the last valuation made by the stockholders, even though such valuation was not made within the year preceding the date of the decedent's death.

The value of the stock as above stated or as same may be determined from time to time hereafter is or shall be inclusive of any value referable to the goodwill of the corporation as a going concern.

Arbitration Rather than appraisal, the agreement may provide for an **arbitration** among independent arbitrators, who will conduct whatever investigation may be necessary to ascertain the value of the stock. This objective determination by independent third parties may be desirable, but is usually expensive and only serves to resolve a dispute rather than establish a true reflection of the value of the Company's stock. If arbitration is to be used as a method of determining the value of shares, it is advisable to describe the qualifications of the arbitrator in the agreement. For example, if the shares of a medical professional corporation are being

evaluated, it would be best to have an arbitrator who is familiar with and has experience in the business of running a medical practice. It is also important to provide that the parties agree to be bound by the decision of the arbitrator and that the decision can be enforced by a court, if necessary. Otherwise, it would be possible for a disappointed party to simply ignore the arbitrator's determination of value, thereby thwarting the purpose of this clause in the agreement.

EXAMPLE**Value Determined by Arbitration**

The shareholder shall notify the corporation of the price at which he or she is willing to sell the stock, which notification shall contain the name of one arbitrator. The corporation shall, within thirty days thereafter, accept the offer, or by notice to the shareholder in writing, name a second arbitrator, and these two shall name a third. All arbitrators named must have at least five years experience in a business similar to the business of the corporation. It shall then be the duty of the arbitrators to ascertain the value of the stock, and if any arbitrator shall neglect or refuse to appear at any meeting appointed by the arbitrators, a majority may act in the absence of such arbitrator. The decision of the arbitrator(s) shall be binding upon all parties, and all parties agree that the decision may be enforced in any court of competent jurisdiction.

Terms of Payment The agreement should specify the procedure and terms of payment when the transfer of shares is accomplished. The purchasers may prefer to extend payment over a period of time, while the seller may prefer immediate cash. Full payment in cash rarely happens; the most common terms of payment provide for a cash down payment and installment payments for the balance, which may be represented by an interest-bearing promissory note. Installment payments may provide tax benefits to the seller, especially if a large block of valuable stock is the subject of the transfer and there are contingencies reflected that might change or eliminate the promised payments upon the occurrence of certain events. Whenever stock is sold, the seller is required to report any gain received in the year of the sale. A shareholder who sells a large block of stock at one time may incur considerable tax liability by receiving the payments in cash during the year of sale. However, if payments are to be made in installments, and future payments are contingent as to the amount (such as payments that vary depending on subsequent earnings or based upon asset levels of the corporation), the shareholder need report only the amount of the proportionate gain represented by the installments received during the year. This will spread the shareholder's profit on the shares being sold over the period of installments, which may be several years. The installment sale tax treatment now applies no matter how much of the purchase price is received during the year in which the sale is consummated and whether or not the payments extend over two or more installments.¹⁵

By agreeing to extend payments over a period of time, the selling shareholder risks the subsequent insolvency of the purchasers, or the purchasers' unwillingness to pay. This problem can be lessened by providing the selling shareholder with some **security** to protect the payments. The security may be any property pledged as collateral to secure the note, but usually consists of the stock being sold. This means that the selling shareholder may repossess the stock upon default of the obligation. The agreement may specify this right of repossession or may establish an escrow arrangement by placing the shares being transferred in the hands of a third party pending payment of the full purchase price. Escrow terms require the return of the shares to the seller if the obligation is defaulted. If the obligation is paid in full, the shares are delivered to the purchaser. A clause reciting the installment sale requirements and permitting a security interest in the stock follows.

Payment of Purchase Price

EXAMPLE

Not less than one-half the consideration required under the preceding clauses shall be paid in cash, and for the balance, a promissory note(s) of the kind hereinafter described may be given. On failure of the purchaser to settle in the manner required within the period of sixty (60) days from the election to purchase, the seller may rescind this agreement and reestablish the situation that would have existed had it never been made.

A note given for part of the consideration shall provide for annual payments on the principal over a period not to exceed five (5) years from the date of the purchase, at the end of which time the unpaid portion of the principal shall be due and payable, and shall provide for interest at the rate of ten percent (10%) per annum and for optional acceleration of maturity in event of a default in payment of principal or interest. The seller may require the purchaser to secure the payment of a note given for the purchase price by a pledge of all or a portion of the stock.

Whether the selling shareholder will have the right to vote the shares that are security for the installment purchase is a subject of negotiation. Usually, the selling shareholder is allowed to vote the shares only if there is a default in the payment of the installments of the purchase price. Shares of the corporation, as security for the installment payment, may represent worthless collateral, since if the corporation ceased to pay on the installments, it would be likely that the corporation's financial position would have deteriorated so much that the shares might be valueless. In representing a shareholder whose only security is the shares being sold, it is advisable to consider the following additional terms in the security agreement concerning the shares:

1. restrictions upon the payment of distributions or salaries during the time that the shares are held as security;
2. the imposition of an asset-to-liability ratio during the period that the shares are security, so that the corporation will maintain more assets than liabilities while making the installment payments, and the installment payments may be accelerated if the ratio is not maintained;
3. restriction on the corporation's ability to borrow money, sell substantially all of its assets outside of the ordinary course of business, merge, exchange shares, or dissolve during the period that the shares are subject to the restriction;
4. antidilution provisions that will adjust the shares held as security to reflect any stock splits, stock dividends, or other capital reorganization; and
5. terms that facilitate the priority of the security interest in the shares, such as a promise by the company to deliver necessary stock certificates or other documents that may be necessary to perfect the security interest in the particular jurisdiction.

Purchase with Security

EXAMPLE

The deferred portion of the purchase price for any shares purchased under this agreement shall be represented by a promissory note executed by all the purchasing shareholders providing for joint and several liability. Each maker agrees that he or she will pay his or her pro rata portion of each installment of principal and interest as it falls due. The note shall provide for payment of principal in 24 equal quarterly installments with interest on the unpaid balance at the rate of 18% per annum, with full privilege of prepayment of all or any part of the principal at any time without penalty or bonus. Any prepaid sums shall be applied against the installments thereafter falling due in inverse order of their maturity, or against all the remaining installments equally, at the option of the payers. The note shall provide that in case of default, at the election of the holder, the entire sum of principal and interest will be immediately due and payable, and that the makers shall pay reasonable attorneys' fees to the holder in the event that such suit is commenced because of default. The note shall be secured by a pledge of all the shares being purchased in the transaction to which the note relates, and of all other shares owned by the purchasing shareholders. The note shall further be secured by a deed of trust on the real property of the corporation, and a security interest in all

(continued)

EXAMPLE*(continued)*

personal property owned by the corporation. The pledge agreements and other agreements required to effect and execute such pledges shall contain such other terms and provisions as may be customary and reasonable. As long as no default occurs in payments on the note, the purchaser shall be entitled to vote the shares; however, dividends shall be paid to the holder of the note as a prepayment of principal. The purchaser shall expressly waive demand, notice of default, and notice of sale, and shall consent to public or private sale of the shares in the event of default, in whole or in lots at the option of the pledge holder, and the seller shall have the right to purchase at the sale.

It is preferable for the shareholder to obtain security other than the shares being transferred as collateral for installment payments under a share transfer agreement. The preceding example illustrates a security interest in personal property of the corporation and a mortgage on the corporation's real estate. If the corporation is not the purchaser, other personal or real property of the purchasing shareholders should be considered. The terms of the security must be negotiated, and the corporation's counsel should be particularly sensitive to the impairment on the corporation's borrowing power by the grant of a security to the shareholder whose shares are being purchased. Appropriate subordination provisions may be included in the security documents to permit the corporation to borrow for normal operating reasons.

Funding of the Agreement through Insurance The corporation may use life insurance, disability insurance, or other insurance contracts as a method of **funding** a buyout agreement. These funding techniques are especially effective if the event triggering the buyout is death or disability. Other insurance contracts are also available for retirement or termination of employment.

A principal determination is whether all or some of the shareholders should or can be insured. A problem may arise when there are differences in ages, such as when one shareholder is over sixty-five and others are under thirty, or when one or more of the shareholders is not insurable because of physical infirmities. When the corporation purchases the life insurance policies funding the buyout agreement, the shareholders automatically bear the cost in proportion to their ownership interests in the corporation. If the majority shareholder is the oldest, that shareholder has a disadvantage. If all of the shareholders are roughly in the same age category for insurance purposes, the cost of insurance is spread more equitably. Advantages of corporation ownership of the policies include having fewer policies and more easily ensuring that the premiums are timely paid and that the policies remain in effect. The shareholders have statutory rights to access to the corporation's books and can verify the information given to them about the status of the policies.¹⁶

A buyout agreement funded with life insurance usually causes the last survivor or survivors to come out ahead. The problem may be illustrated by the case of a corporation valued at \$100,000 with four shareholders. The interest of each shareholder is worth \$25,000, and the corporation purchases insurance policies for \$25,000 on the life of each shareholder. The estate of the first shareholder to die receives \$25,000, and each remaining shareholder then has a one-third interest, with a value of \$33,333.33, in a corporation still worth \$100,000. The last survivor gets the entire corporation. One way to avoid this problem is to increase the insurance on the survivors' lives, but this may be too expensive and does not entirely eliminate the windfall to the longer-surviving shareholders.

The corporation may not deduct life insurance premiums paid on policies on shareholders' lives if it is directly or indirectly a beneficiary under those policies.¹⁷ This rule ordinarily prevents the corporation from deducting premiums for life insurance used to fund the corporation's purchase of its stock whether the corporation is the designated beneficiary or the indirect recipient of the proceeds through a trustee or a member of the decedent's family. If the shareholder is the beneficiary, some portion of the insurance proceeds may be included in the shareholder's gross estate for estate tax purposes.¹⁸

As alternative funding methods, the corporation may build up cash or liquid investments as a reserve with which to purchase the shareholder's interest. This creates an evaluation problem, especially when book value is considered the appropriate formula for determining the price of the purchased shares, in that the existence of the reserve enhances the value of the corporation and, therefore, may increase the amount to be paid at the buy-out. In addition, the corporation's inability to use the money in the reserve may handicap its day-to-day operations, and the fund may be reachable by its creditors. There is further risk that the accumulated earnings tax will be imposed on such a reserve under the Internal Revenue Code.¹⁹

Life insurance may be used to fund a **cross-purchase agreement** of the shareholders, but the tax and nontax factors should be considered carefully. If the shareholders are employees, they may pay the premiums out of their corporate salaries, which are deductible by the corporation if the compensation is reasonable.²⁰ If the shareholders are using dividend income from the corporation to pay the premiums, the corporate deduction is not available. Direct payments of the insurance premiums by the corporation may be held to constitute dividends to a shareholder. To avoid estate tax problems, each shareholder should purchase insurance on the life of each other shareholder, but not on his or her own life.²¹ A factor weighing against life insurance funding is the potential windfall for the surviving shareholders.

Especially when the cross-purchase agreement among shareholders is funded by life insurance, a trustee is often appointed to perform certain functions. Stock certificates may be deposited with the trustee, and the trustee may receive payments and handle the paperwork attendant to such transfers. The trustee also may send notices and perform calculations as to the number of shares the offeree may purchase. The shareholders may prefer that a disinterested person perform these functions, and the agreement should provide the manner in which the trustee will be selected. The agreement should also provide the manner in which the cost for the trustee's services will be paid.

Cross-Purchase Insurance Agreement

EXAMPLE

In order to fund the payment of the purchase price for the shares to be purchased under this agreement on the death of any shareholder, each shareholder shall maintain in full force and effect a policy of life insurance on the life of each other shareholder in the face amount shown on Exhibit A to this agreement. Each such policy is listed and described in the Exhibit, and any additional policies hereafter acquired for the same purpose shall also be listed in the Exhibit. Each policy belongs solely to the shareholder who applied for it and, subject to the provisions of this agreement, the owner of each policy reserves all the powers and rights of ownership of it. Each such owner shall be named as the primary beneficiary of his or her respective policies, and shall pay all premiums on them as they become due. No shareholder shall exercise any of the powers of ownership of any of the policies by changing the named beneficiary, canceling the policy, electing optional methods of payment, converting the policy, borrowing against it, or in any other way changing its nature, value, or the rights under the policy. Any dividends paid on any of the policies before maturity or the insured's death shall be paid to the policy owner and shall not be subject to this agreement. Receipts showing payment of premiums shall be delivered to the Secretary of the company no less than 20 days before each date upon which the respective premiums are due, and the receipts shall be held by the Secretary for inspection by all shareholders.

If one shareholder dies, that shareholder will have owned policies of insurance on the lives of fellow shareholders. Accordingly, it is desirable to provide for the disposition of any unneeded policies in the agreement.

EXAMPLE**Unneeded Insurance Policies**

On the death of any shareholder, each of the surviving shareholders shall have the option for 90 days to purchase the policy of life insurance on the shareholder's life owned by the decedent. Each shareholder shall also have the right to purchase the policies on that shareholder's life within 90 days after the sale or transfer of all that shareholder's shares, or after termination of this agreement. This option shall be exercised by delivery of written notice of exercise to the decedent's personal representative or to the owner of the policy and by payment of the purchase price in cash. The purchase price shall be equal to the cash surrender value of the policy, reduced by any unpaid loans made against the policy. If the option is not exercised within that period, the policy owner may surrender the policy for its cash value or dispose of it in any other way he or she sees fit. The parties agree to execute any releases and assignments that may be necessary to effectuate the provisions of this paragraph.

Legend on Certificates To ensure that shareholders will not violate the agreement and provide a purchase of the shares with stock certificates free from the transfer restrictions, it is necessary to place a conspicuous **legend** on each certificate for the shares, the terms of which should be specified by the agreement. Section 8-204 of the Uniform Commercial Code states that a purchaser of stock that is subject to a stock transfer restriction will purchase the shares free from the transfer restriction unless the certificate contains a conspicuous notation of the restriction or unless the purchaser has actual knowledge of the restriction. Section 6.27 of the Model Business Corporation Act also contains this rule.

The agreement should require that each shareholder shall surrender the certificate representing the shares to permit the inscription of an appropriate legend. The legend may provide the actual terms of the restriction, or simply say that the shares shall not be transferred, encumbered, or in any way alienated except under the terms of the agreement, referring to the agreement by date and indicating a place at which the agreement may be inspected.

EXAMPLE**Legend**

Each share certificate, when issued, shall have a conspicuously endorsed legend on its face with the following words: "Sale, transfer, or hypothecation of the shares represented by this certificate is restricted by the provisions of a buyout agreement among the shareholders and the Company dated November 28, 2005, a copy of which may be inspected at the principal office of the Company and all the provisions of which are incorporated by reference in this certificate." A copy of this agreement shall be delivered to the Secretary of the company, and shall be shown by the Secretary to any person making any inquiry about it.

Miscellaneous Provisions Several additional considerations must be reviewed in preparing an agreement regarding share ownership. Since the transfer of shares under the agreement may affect other corporate activities and may be regulated with respect to securities law aspects by state and federal agencies, special issues concerning transfer of shares must be reviewed with the client and considered in drafting the agreement. For example, it is typical to require that the corporation's counsel render an opinion that the transfer of the shares does not violate any federal or state securities laws as a condition to any transfer of the shares under the agreement.

If the corporation has previously elected Subchapter S status for taxation, it may be desirable to continue the Subchapter S election even though shares are being transferred under a stock transfer agreement. Each shareholder's consent is desirable to provide for taxation of the corporation under Subchapter S, and the agreement should provide that any transferee of the shares under the share transfer agreement will execute required documents and consent to the election.

Subchapter S Election

EXAMPLE

The Company and each of the shareholders agree to execute such documents and consents and to cause them to be delivered in a timely manner to the Internal Revenue Service in order to cause the Company to elect to be taxed as a small business corporation under section 1361 of the Internal Revenue Code of 1986. Each shareholder shall cause any transferee of any of his or her shares to file in a timely manner the required consent to the election. Notwithstanding any provision of this agreement to the contrary, no transfer of any of the Company’s shares shall be made by any shareholder to any corporation, partnership, or trust, or to any other transferee, if the effect of the transfer would cause the election to be lost or revoked.

In the case of death or disability of a shareholder, the shareholder’s spouse will have certain rights to assets of the shareholder. These assets include the shares of stock owned by the shareholder. The agreement should contemplate the potential claims to be made by spouses and heirs of the shareholder, which may be inconsistent with the terms of the agreement. For example, the spouse of a married shareholder who dies without a will is entitled in most states to receive the shares from the decedent’s estate. The spouse may prefer to keep the shares even though the shareholder agreement requires that they be sold to the corporation or the other shareholders. Since the spouse is not a party to the agreement, it may not be possible to force the spouse to sell the shares without additional consent or waiver documents from the spouse. The shareholders should also be required to take any steps that may be necessary to reconcile personal estate documents, such as wills and trusts, with the shareholder agreement.

Spouse’s Consent

EXAMPLE

I acknowledge that I have read the foregoing agreement and that I know its contents. I am aware that by its provisions my spouse agrees to sell all of his or her shares to the Company, including my community interest in them, if any, on the occurrence of certain events. I hereby consent to the sale, approve of the provisions of the agreement, and agree that those shares and my interest in them are subject to the provisions of the agreement and that I will take no action at any time to hinder operation of the agreement on those shares or my interest in them.

Wills

EXAMPLE

Each shareholder agrees to include in his or her will a direction and authorization to his or her executor to comply with the provisions of this agreement and to sell his or her shares in accordance with this agreement; however, the failure of any shareholder to do so shall not affect the validity or enforceability of this agreement.

KEY TERMS

share transfer restriction
 shareholder voting agreement
 voting trust
 stock voting agreement
 minority nominee
 savings clause
 mandatory buyout or sellout arrangements
 good faith offer

option to purchase
 all or nothing purchase
 forced buyout provision
 Jeopardy Auction/Wheel of Fortune provision
 Deadwood Draw provision
 firm price
 adjusted stated value
 multiple of earnings formula

savings provision
 matching price provision
 appraisal
 going-concern value
 arbitration
 security
 insurance funding
 cross-purchase insurance agreement
 legend on certificate

WEB RESOURCES

Access to state corporate laws relating to voting and share restriction agreements may be obtained through the Legal Information Institute maintained at the Cornell Law School:

<<http://www.law.cornell.edu>>

A variety of business forms and articles, including buy-sell agreements and other share transfer restrictions are available as Law Commerce™, a member of the LexisNexis Group. Several research pages and best-selling forms and agreements are available in an electronic marketplace at

<<http://www.lawcommerce.com>>

Various resources are available for sample forms and information about voting control agreements and share transfer restrictions or buy-sell agreements, including the following:

<<http://www.toolkit.cch.com>>

<<http://www.findlaw.com>>

<<http://www.tannedfeet.com>>

<<http://www.lectlaw.com>>

<<http://www.ilrg.com>>



CASES

RINGLING BROS.-BARNUM & BAILEY COMBINED SHOWS, INC. v. RINGLING

53 A.2d 441 (Del. 1947)

PEARSON, JUDGE

The Court of Chancery was called upon to review an attempted election of directors at the 1946 annual stockholders meeting of the corporate defendant. The pivotal questions concern an agreement between two of the three present stockholders, and particularly the effect of this agreement with relation to the exercise of voting rights by these two stockholders. At the time of the meeting, the corporation had outstanding 1000 shares of capital stock held as follows: 315 by petitioner Edith Conway Ringling; 315 by defendant Aubrey B. Ringling Haley (individually or as executrix and legatee of a deceased husband); and 370 by defendant John Ringling North. The purpose of the meeting was to elect the entire board of seven directors. The shares could be voted cumulatively. Mrs. Ringling asserts that by virtue of the operation of an agreement between her and Mrs. Haley, the latter was bound to vote her shares for an adjournment of the meeting, or in the alternative, for a certain slate of directors. Mrs. Haley contends that she was not so bound for reason that the agreement was invalid, or at least revocable.

The two ladies entered into the agreement in 1941. It makes like provisions concerning stock of the corporate defendant and of another corporation, but in this case, we are

concerned solely with the agreement as it affects the voting of stock of the corporate defendant. The agreement recites that each party was the owner “subject only to possible claims of creditors of the estates of Charles Ringling and Richard Ringling, respectively” (deceased husbands of the parties), of 300 shares of the capital stock of the defendant corporation; that in 1938 these shares had been deposited under a voting trust agreement which would terminate in 1947, or earlier, upon the elimination of certain liability of the corporation; that each party also owned 15 shares individually; that the parties had “entered into an agreement in April 1934 providing for joint action by them in matters affecting their ownership of stock and interest in” the corporate defendant; that the parties desired “to continue to act jointly in all matters relating to their stock ownership or interest in” the corporate defendant (and the other corporation). The agreement then provides as follows:

* * *

“2. In exercising any voting rights to which either party may be entitled by virtue of ownership of stock or voting trust certificates held by them in either of said corporation, each party will consult and confer with the other 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.

“3. In the event the parties fail to agree with respect to any matter covered by paragraph 2 above, the question in disagreement shall be submitted for arbitration to Karl D. Loos, of Washington, D.C. as arbitrator and his decision thereon shall be binding upon the parties hereto. Such arbitration shall be exercised to the end of assuring for the respective corporations good management and such participation therein by the members of the Ringling family as the experience, capacity and ability of each may warrant.

The parties may at any time by written agreement designate any other individual to act as arbitrator in lieu of said Loos.”

* * *

The Mr. Loos mentioned in the agreement is an attorney and has represented both parties since 1937, and, before and after the voting trust was terminated in late 1942, advised them with respect to the exercise of their voting rights. At the annual meetings in 1943 and the two following years, the parties voted their shares in accordance with mutual understandings arrived at as a result of discussions. In each of these years, they elected five of the seven directors. Mrs. Ringling and Mrs. Haley each had sufficient votes, independently of the other, to elect two of the seven directors. By both voting for an additional candidate, they could be sure of his election regardless of how Mr. North, the remaining stockholder, might vote.¹

Some weeks before the 1946 meeting, they discussed with Mr. Loos the matter of voting for directors. They were in accord that Mrs. Ringling should cast sufficient votes to elect herself and her son; and that Mrs. Haley should elect herself and her husband; but they did not agree upon a fifth director. The day before the meeting, the discussions were continued, Mrs. Haley being represented by her husband since she could not be present because of illness. In a conversation with Mr. Loos, Mr. Haley indicated that he would make a motion for an adjournment of the meeting for sixty days, in order to give the ladies additional time to come to an agreement about their voting. On the morning of the meeting, however, he stated that because of something Mrs. Ringling had done, he would not consent to a postponement. Mrs. Ringling then made a demand upon Mr. Loos to act under the third paragraph of the agreement “to arbitrate the disagreement” between her and Mrs. Haley in connection with the manner in which the stock of the two ladies should be voted. At the opening of the meeting, Mr. Loos read the written demand and stated that he determined and directed that the stock of both ladies be voted for an adjournment of sixty days. Mrs. Ringling then made a motion for adjournment and voted for it. Mr. Haley, as proxy for his wife, and Mr. North voted against the motion. Mrs. Ringling (herself or through her attorney, it is immaterial which), objected to the voting of Mrs. Haley’s stock

in any manner other than in accordance with Mr. Loos’ direction. The chairman ruled that the stock could not be voted contrary to such direction, and declared the motion for adjournment had carried. Nevertheless, the meeting proceeded to the election of directors. Mrs. Ringling stated that she would continue in the meeting “but without prejudice to her position with respect to the voting of the stock and the fact that adjournment had not been taken.” Mr. Loos directed Mrs. Ringling to cast her votes

882 for Mrs. Ringling,
882 for her son, Robert, and
441 for a Mr. Dunn,

who had been a member of the board for several years. She complied. Mr. Loos directed that Mrs. Haley’s votes be cast

882 for Mrs. Haley,
882 for Mr. Haley, and
441 for Mr. Dunn.

Instead of complying, Mr. Haley attempted to vote his wife’s shares

1103 for Mrs. Haley, and
1102 for Mr. Haley.

Mr. North voted his shares

864 for a Mr. Woods,
863 for a Mr. Griffin, and
863 for Mr. North.

The chairman ruled that the five candidates proposed by Mr. Loos, together with Messrs. Woods and North, were elected. The Haley-North group disputed this ruling insofar as it declared the election of Mr. Dunn; and insisted that Mr. Griffin, instead, had been elected. A directors’ meeting followed in which Mrs. Ringling participated after stating that she would do so “without prejudice to her position that the stockholders’ meeting had been adjourned and that the directors’ meeting was not properly held.” Mr. Dunn and Mr. Griffin, although each was challenged by an opposing faction, attempted to join in voting as directors for different slates of officers. Soon after the meeting, Mrs. Ringling instituted this proceeding.

* * *

Having examined what the parties sought to provide by the agreement, we come now to defendants’ contention that the voting provisions are illegal and revocable. They say that the courts of this state have definitely established the doctrine “that there can be no agreement, or any device whatsoever, by which the voting power of stock of a Delaware corporation may be irrevocably separated from the ownership of the stock, except by an agreement which complies with Section 18” of the Corporation Law, Rev.Code 1935, § 2050, and except by a proxy coupled with an interest.

* * *

1. Each lady was entitled to cast 2205 votes (since each had the cumulative voting rights of 315 shares, and there were 7 vacancies in the directorate). The sum of the votes of both is 4410, which is sufficient to allow 882 votes for each of 5 persons. Mr. North, holding 370 shares, was entitled to cast 2590 votes, which obviously cannot be divided so as to give to more than two candidates as many as 882 votes each. It will be observed that in order for Mrs. Ringling and Mrs. Haley to be sure to elect five directors (regardless of how Mr. North might vote) they must act together in the sense that their combined votes must be divided among five different candidates and at least one of the five must be voted for by both Mrs. Ringling and Mrs. Haley.

The statute reads, in part, as follows: “Sec. 18. Fiduciary Stockholders; Voting Power of; Voting Trusts:—Persons holding stock in a fiduciary capacity shall be entitled to vote the shares so held, and persons whose stock is pledged shall be entitled to vote, unless in the transfer by the pledgor on the books of the corporation he shall have expressly empowered the pledgee to vote thereon, in which case only the pledgee, or his proxy may represent said stock and vote thereon.

“One or more stockholders may by agreement in writing deposit capital stock of an original issue with or transfer capital stock to any person or persons, or corporation or corporations authorized to act as trustee, for the purpose of vesting in said person or persons, corporation or corporations, who may be designated Voting Trustee or Voting Trustees, the right to vote thereon for any period of time determined by such agreement, not exceeding ten years, upon the terms and conditions stated in such agreement. Such agreement may contain any other lawful provisions not inconsistent with said purpose. * * * Said Voting Trustees may vote upon the stock so issued or transferred during the period in such agreement specified; stock standing in the names of such Voting Trustees may be voted either in person or by proxy, and in voting said stock, such Voting Trustees shall incur no responsibility as stockholder, trustee or otherwise, except for their own individual malfeasance.”

In our view, neither the cases nor the statute sustain the rule for which the defendants contend.

* * *

[T]he statute does not purport to deal with agreements whereby shareholders attempt to bind each other as to how they shall vote their shares. Various forms of such pooling agreements, as they are sometimes called, have been held valid and have been distinguished from voting trusts. [Citations omitted] We think the particular agreement before us does not violate Section 18 or constitute an attempted evasion of its requirements, and is not illegal for any other reason. Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders. *Heil v. Standard G. & E. Co.*, 17 Del. Ch. 214, 151 A. 303. The ownership of voting stock imposes no legal duty to vote at all. A group of shareholders may, without impropriety, vote their respective shares so as to obtain advantages of

concerted action. They may lawfully contract with each other to vote in the future in such way as they, or a majority of their group, from time to time determine. (See authorities listed above.) Reasonable provisions for cases of failure of the group to reach a determination because of an even division in their ranks seem unobjectionable. The provision here for submission to the arbitrator is plainly designed as a deadlock-breaking measure, and the arbitrator’s decision cannot be enforced unless at least one of the parties (entitled to cast one-half of their combined votes) is willing that it be enforced. We find the provision reasonable. It does not appear that the agreement enables the parties to take any unlawful advantage of the outside shareholder, or of any other person. It offends no rule of law or public policy of this state of which we are aware.

Legal consideration for the promises of each party is supplied by the mutual promises of the other party. The undertaking to vote in accordance with the arbitrator’s decision is a valid contract. The good faith of the arbitrator’s action has not been challenged and, indeed, the record indicates that no such challenge could be supported. Accordingly, the failure of Mrs. Haley to exercise her voting rights in accordance with his decision was a breach of her contract. It is no extenuation of the breach that her votes were cast for two of the three candidates directed by the arbitrator. His directions to her were part of a single plan or course of action for the voting of the shares of both parties to the agreement, calculated to utilize an advantage of joint action by them which would bring about the election of an additional director. The actual voting of Mrs. Haley’s shares frustrates that plan to such an extent that it should not be treated as a partial performance of her contract.

* * *

[W]e have concluded that the election should not be declared invalid, but that effect should be given to a rejection of the votes representing Mrs. Haley’s shares. No other relief seems appropriate in this proceeding. Mr. North’s vote against the motion for adjournment was sufficient to defeat it. With respect to the election of directors, the return of the inspectors should be corrected to show a rejection of Mrs. Haley’s votes, and to declare the election of the six persons for whom Mr. North and Mrs. Ringling voted.

* * *

An order should be entered directing a modification of the order of the Court of Chancery in accordance with this opinion.

LING & CO., INC. v. TRINITY SAVINGS & LOAN ASSOCIATION

482 S.W.2d 841 (Texas 1972)

REAVLEY, JUSTICE

Trinity Savings and Loan Association sued Bruce W. Bowman for the balance owed on a promissory note and also to foreclose on a certificate for 1500 shares of Class A Common Stock in Ling & Company, Inc. pledged by Bowman

to secure payment of the note. Ling & Company was made a party to the suit by Trinity Savings and Loan because of Ling & Company's insistence that the transfer of its stock was subject to restrictions that were unfulfilled. Bowman did not appear and has not appealed from the judgment against him. The trial court entered summary judgment in favor of Trinity Savings and Loan, against the contentions of Ling & Company, foreclosing the security interest in the stock and ordering it sold. The court of civil appeals affirmed. 470 S.W.2d 441. We reverse the judgments and remand the case to the trial court.

The objection to the foreclosure and public sale of this stock is based upon restrictions imposed upon the transfer of the stock by the articles of incorporation of Ling & Company. It is conceded that no offer of sale has been made to the other holders of this class of stock and that the approval of the pledge of the stock has not been obtained from the New York Stock Exchange. It is the position of Trinity Savings and Loan that all of the restrictions upon the transfer of any interest in this stock are invalid and of no effect. This has been the holding of the courts below.

The face and back of the stock certificate are reproduced and attached to this opinion.

The restrictions appear in Article Four of the Ling & Company articles of incorporation, as amended and filed with the Secretary of State in 1968. Section D requires the holder to obtain written approval of the New York Stock Exchange prior to the sale or encumbrance of the stock if, at the time, Ling & Company is a member corporation of the Exchange. Then Section E(4) prevents the sale of the stock without first affording the corporation the opportunity to buy and, if it fails to purchase, giving that opportunity to all holders of the same class of stock. The method of computation of the price, based upon the corporate books, is provided in this section of the articles.

The court of civil appeals struck down the restrictions for three reasons: the lack of conspicuous notice thereof on the stock certificate, the unreasonableness of the restrictions, and statutory prohibition against an option in favor of other stockholders whenever they number more than twenty. These objections will be examined in that order.

CONSPICUOUSNESS

The Texas Business Corporation Act as amended in 1957, V.A.T.S. Bus. Corp. Act, art. 2.22, subd. A, provides that a corporation may impose restrictions on the transfer of its stock if they are "expressly set forth in the articles of incorporation . . . and . . . copied at length or in summary form on the face or so copied on the back and referred to on the face of each certificate . . ." Article 2.19, subd. F, enacted by the Legislature at the same time, permits the incorporation by reference on the face or back of the certificate of the provision of the articles of incorporation which restricts the transfer of the stock. The court of civil appeals objected to the general reference to the articles of incorporation and the

failure to print the full conditions imposed upon the transfer of the shares. However, reference is made on the face of the certificate to the restrictions described on the reverse side; the notice on the reverse side refers to the particular article of the articles of incorporation as restricting the transfer or encumbrance and requiring "the holder hereof to grant options to purchase the shares represented hereby first to the Corporation and then pro rata to the other holders of the class A Common Stock . . ." We hold that the content of the certificate complies with the requirements of the Texas Business Corporation Act.

There remains the requirement of the Texas Business and Commerce Code that the restriction or reference thereto on the certificate must be conspicuous. Sec. 8.204, V.T.C.A. Bus. & C., requires that a restriction on transferability be "noted conspicuously on the security." Sec. 1.201(10) of the Business and Commerce Code defines "conspicuous" and makes the determination a question of law for the court to decide. It is provided that a conspicuous term is so written as to be noticed by a reasonable person. Examples of conspicuous matter are given there as a "printed heading in capitals . . . [or] larger or other contrasting type or color." This means that something must appear on the face of the certificate to attract the attention of a reasonable person when he looks at it. *Hunt v. Perkins Machinery Co.*, 352 Mass. 535, 226 N.E.2d 228 (1967); *Boeing Airplane Co. v. O'Malley*, 329 F.2d 585 (8th Cir. 1964); 1 Anderson, Uniform Commercial Code 87 (2nd ed. 1970). The line of print on the face of the Ling & Company certificate does not stand out and cannot be considered conspicuous.

Our holding that the restriction is not noted conspicuously on the certificate does not entitle Trinity Savings and Loan to a summary judgment under this record. Sec. 8.204 of the Business and Commerce Code provides that the restriction is effective against a person with actual knowledge of it. The record does not establish conclusively that Trinity Savings and Loan lacked knowledge of the restriction on January 28, 1969, the date the record indicates when Bowman executed an assignment of this stock to Trinity Savings and Loan.

REASONABLENESS

Art. 2.22, subd. A of the Texas Business Corporation Act provides that a corporation may impose restrictions on disposition of its stock if the restrictions "do not unreasonably restrain or prohibit transferability." The court of civil appeals has held that the restrictions on the transferability of this stock are unreasonable for two reasons: because of the required approval of the New York Stock Exchange and because of successive options to purchase given the corporation and the other holders of the same class of stock.

Ling & Company in its brief states that it was a brokerage house member of the New York Stock Exchange at an earlier time and that Rule 315 of the Exchange required approval of any sale or pledge of the stock. Under these circumstances

we must disagree with the court of civil appeals holding that this provision of article 4D of the articles of incorporation is "arbitrary, capricious, and unreasonable." Nothing appears in the summary judgment proof on this matter, and the mere provision in the article is no cause for vitiating the restrictions as a matter of law.

It was also held by the intermediate court that it is unreasonable to require a shareholder to notify all other

record holders of Class A Common Stock of his intent to sell and to give the other holders a ten day option to buy. The record does not reveal the number of holders of this class of stock; we only know that there are more than twenty. We find nothing unusual or oppressive in these first option provisions. See *Coleman v. Kettering*, 289 S.W.2d 953 (Tex.Civ.App.1956, no writ); *2 O'Neal, Close Corporations*, § 7.13 (1971). Conceivably the number of stock-



For Value Received, hereby sell, assign, and transfer unto _____ Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint _____ Attorney to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises Dated _____ 19____ In presence of _____

NOTICE: THE SIGNATURE OF THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS SHOWN FOR BOTH THE ATTORNEY AND ASSIGNMENT OF SAID CAPITAL STOCK (SEE PAGE 10)

NOTICE: The shares represented by this certificate are subject to all the terms, conditions and provisions of the Articles of Incorporation of the Corporation, as the same may be amended from time to time, which Articles are incorporated herein by reference as though fully set forth herein. Copies of the Articles of Incorporation may be obtained from the Secretary of State of the State of Texas or upon written request therefor from the Secretary of the Corporation. Reference is specifically made to the provisions of Article Four of the Articles of Incorporation which set forth the designations, preferences, limitations and relative rights of the shares of each class of capital stock authorized to be issued, which deny pre-emptive rights, prohibit cumulative voting, restrict the transfer, sale, assignment, pledge, hypothecation or encumbrance of any of the shares represented hereby under certain conditions, and which under certain conditions require the holder hereof to grant options to purchase the shares represented hereby first to the Corporation and then pro rata to the other holders of the Class A Common Stock, all as set forth in said Article Four. Reference is also specifically made to the provisions of Article Nine which vests the power to adopt, alter, amend or repeal the by-laws in the Board of Directors except to the extent such power may be modified or divested by action of shareholders representing a majority of the holders of the Class A Common Stock.

holders might be so great as to make the burden too heavy upon the stockholder who wishes to sell and, at the same time, dispel any justification for contending that there exists a reasonable corporate purpose in restricting the ownership. But there is no showing of that nature in this summary judgment record.

STATUTORY LIMIT ON OPTIONEES

Art. 2.22, subd. B of the Texas Business Corporation Act provides that, in addition to other reasonable restrictions, any of the following restrictions may be imposed upon the transfer of corporate shares:

- (1) Restrictions reasonably defining pre-emptive or prior rights of the corporation or its shareholders of record, to purchase any of its shares offered for transfer.
- (2) Restrictions reasonably defining rights and obligations of the holders of shares of any class, in connection with buy-and-sell agreements binding on all holders of shares of that class, so long as there are no more than twenty (20) holders of record of such class.
- (3) Restrictions reasonably defining rights of the corporation or of any other person or persons,

granted as an option or options or refusal or refusals on any shares.

The court of civil appeals regarded subsection (2) as being applicable to the stock restriction in this case. Since it was stipulated that there were more than twenty holders of record of Class A stock, it has been held that the restriction fails for this reason. We disagree. Subsection (2) is not applicable to the Ling & Company restriction. It seems that a “buy and sell agreement” usually refers to a contract between shareholders rather than a restriction imposed by the corporation. In any event, there is no obligation to purchase this stock placed upon anyone, and these restrictions can only be considered as options and not “buy and sell agreements.” 2 O’Neal, *Close Corporations*, § 7.10 (1971); *Fletcher Cyc. Corp.* § 5461.1 (1971).

The summary judgment proof does not justify the holding that restrictions on the transfer of this stock were ineffective as to Trinity Savings and Loan Association. The judgment below is reversed and the cause is remanded to the trial court.

DANIEL, J., concurs in result.

PROBLEMS

1. What steps can be taken to warn a potential purchaser of shares in a corporation that the shares of stock are restricted by a shareholder ownership agreement? What are the consequences of failing to take such steps?
2. State the advantages and disadvantages of the following methods of determining a price for a shareholder’s buy-sell agreement. Also indicate the type of business in which each method would be most useful and representative of the actual value of the stock:
 - a. book value formula;
 - b. capitalized earnings multiple formula;
 - c. appraised method;
 - d. arbitration; and
 - e. firm price method.
3. State the reasons why you would recommend or discourage the following types of voting agreements or arrangements for a client:
 - a. a voting trust;
 - b. a stock voting agreement; and
 - c. an irrevocable proxy.
4. When a stock is subject to a share transfer restriction, a third-party purchaser will take free from the restriction upon purchase of the stock unless
 - a. the purchaser has actual knowledge of the restriction;
 - b. the restriction is noted conspicuously on the certificate;
 - c. the corporation is notified of the sale;
 - d. a and b but not c;
 - e. b and c but not a;
 - f. a and c but not b.
5. Which of the following clauses has the most restrictive effect on a shareholder attempting to sell shares?
 - a. The price shall be paid in equal installments over a period of two months.
 - b. The price shall be book value or the same as any bona fide offer, whichever is higher.
 - c. The price shall be book value or the same as any bona fide offer, whichever is lower.
 - d. The price shall be determined in the discretion of the shareholder.
6. Which of the following is a requirement for effectiveness of a voting trust?
 - a. A voting trust certificate is issued.
 - b. A copy of the agreement is deposited with the corporation.
 - c. The other shareholders, not represented by the voting trust, are notified of the existence of the agreement.
 - d. All of the above.

PRACTICE ASSIGNMENTS

1. Erika Bolsinger and Susan Stroud are equal shareholders of Glorified Technologies, Inc., a corporation they formed in 1990. The business is prospering, and Erika and Susan are concerned about the possibility of losing control of the business as it expands. They want to preserve their harmonious working relationship. Erika does not intend to leave the active participation in the business in the near future and does not suspect any such interest by Susan. If Susan were to leave, however, she would take with her considerable technical know-how and expertise in computer programming and software development. Susan would be very capable of competing with the corporation if she were to leave. Both women desire protection against the other party selling her shares to an outsider. They are willing to sign an agreement with each other, each promising to sell her shares to the other party before selling to a third party. Their primary objective is to discourage the sale of the shares, but if the shares are sold, they each want to be certain that the other receives a fair price. Either party would be

satisfied if the selling shareholder's shares were purchased by the corporation and held as treasury shares or canceled. Erika cautions, however, that if the corporation were to buy the stock, it would be very important to avoid dilution of the available working capital, which could be accomplished by a long-term payout provision.

Draft an agreement on Erika's behalf to accomplish the foregoing objectives, incorporating any suggestions you would make.

2. Draft a memorandum for a client stating the advantages and disadvantages of including agreed voting provisions in
 - a. the articles of incorporation;
 - b. the bylaws;
 - c. a voting trust agreement;
 - d. a stock voting agreement; and
 - e. an employment agreement.
3. Review your state corporation code and list the statutory requirements for the formation of a voting trust.

ENDNOTES

1. See "Close Corporations" in Chapter 7.
2. See "The Articles of Incorporation" in Chapter 8; "Shareholder Business and Vote Required" in Chapter 10.
3. See Chapter 15.
4. See "Shareholder Meetings" in Chapter 10.
5. See Model Business Corporation Act (hereinafter M.B.C.A.) § 7.32 and Model Statutory Close Corporation Supplement § 20(c); Delaware's close corporation statute allows written shareholder agreements that interfere with the discretion of the directors, but the shareholders are responsible for acts controlled by the agreement. Del. Code Ann. tit. 8, § 350.
6. M.B.C.A. § 7.30.
7. E.g., Minnesota, Minn. Stat. Ann. § 302A.453 (West); Nevada, Nev. Rev. Stat. § 78.365.
8. New Jersey, N. J. Stat. Ann. § 14A:5-20 (West); Maine, Me. Rev. Stat. Ann. tit. 13A, § 619 (West).

9. M.B.C.A. § 7.30 (b).
10. See the example described in "Shareholder Business and Vote Required" in Chapter 10.
11. See "Corporation's Purchase of Its Own Shares" in Chapter 11.
12. See M.B.C.A. § 6.31.
13. Internal Revenue Code (hereafter I.R.C.) of 1986, 26 U.S.C.A. § 302.
14. See "Involuntary Dissolution" in Chapter 15.
15. I.R.C. of 1986, 26 U.S.C.A. § 453.
16. M.B.C.A. § 16.02.
17. See I.R.C. of 1986, 26 U.S.C.A. § 264 (a).
18. See I.R.C. of 1986, 26 U.S.C.A. § 2042.
19. See I.R.C. of 1986, 26 U.S.C.A. § 531.
20. See I.R.C. of 1986, 26 U.S.C.A. § 162 (a) (1).
21. See I.R.C. of 1986, 26 U.S.C.A. § 2042(2).