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Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances

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In planning for the closely held corporation, counsel should give consideration to the flexibility afforded by a shareholders' agreement. Such an agreement is not, however, without its pitfalls. The author examines the advantages and problems inherent in the use of a shareholders' agreement.

The small, closely held corporation is one of the most common business units in American commerce. Corporations of this type are continuously being formed, liquidated and dissolved. It is the formation, sustenance and termination of these fundamental commercial units that confronts the corporate lawyer with some of the most basic and, at the same time, unique, planning opportunities. These planning opportunities arise primarily because of the virtual identity between the business considerations of the small corporation and the personal financial considerations of its shareholders. Although the small, closely held corporation is, in the eyes of the law, an independent entity, separate and distinct from its shareholders, the fortunes of the corporation and those of its shareholders are normally so intertwined that each aspect of planning at the corporate level necessarily has implications at the shareholder level, and vice versa.

This virtual identity between a closely held corporation and its small number of shareholders is exemplified in, and made more complex by, the different levels of relationship that commonly exist between the corporation and its shareholders. For example, the shareholder is not only, by definition, the proprietor of and ultimate decision maker for the corporation, but in most cases is also a director, officer and employee of the corporation. The shareholder, as an investor, is the source of capital for the corporation, at least initially, while the corporation, as his employer, is often the source of the shareholder's daily living. Because the business of the corporation is often the lifework of a shareholder, its stock is apt to be the single most valuable asset of his personal estate.

In the face of these complex and conflicting relationships, the traditional concepts of corporate operation through charter, by-laws, formal meetings of shareholders and directors and the like, often prove to be of little value in the planning context. This planning void is frequently filled by what has become, under a number of different names and definitions, one of the

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1. Shareholders' agreements are called by a number of different names, depending upon the goals emphasized by the specific agreement and the individual preference of its draftsman. Some of the most common names include: "Restrictive Stock Agreement," "Buy/Sell Agreement," or "Stock Purchase Agreement."
most flexible planning tools available to close corporations—the shareholders’ agreement.

This type of agreement is invariably addressed to the solution of one or more of the infinite problems which are generated by the identity crisis implicit in the maze of corporate-shareholder relationships described above. For example, such an agreement can provide continuity in the shareholder group by restricting the transfer of shares of stock; it can provide liquidity in the personal estates of the shareholders through the use of death buy/our arrangements; it can provide the mechanics for passing control from one generation of shareholders to another; and, it can, when employed at the formation of the corporation, embody a number of basic decisions and policies with respect to the structure and management of the newly-formed entity.

While the shareholders’ agreement is among the most useful planning tools available to counsel for a closely held corporation, it also, because of the factors described above, presents him with some of the most difficult conceptual problems he will have to face, both substantively and ethically. This article will examine, on a practical level, some of the special problems inherent in the preparation of shareholders’ agreements.

**BASIC GOALS AND PRELIMINARY PROBLEMS**

Most shareholders’ agreements are conceived and drafted with a view toward achieving one or more of the following basic goals, all of which are peculiar to closely held corporations and stem from the fundamental identity between such corporations and their shareholders:

1. To assure continuity in the management of the corporation and in the ability of the shareholders to exercise their management powers, at the various levels of shareholder, director and officer, without interference from new shareholders who become members of the shareholder group without their consent. This goal is normally accomplished by provisions imposing restrictions upon the voluntary transfer of the corporation’s stock and creating devices for the retrieval of such stock from persons or entities into whose hands the stock may pass by operation of law or by some other event beyond the control of the shareholder group.

2. To provide the estates of the shareholders with markets for their stock after their death, thereby providing the estates with liquidity to pay death taxes and expenses and to purchase investment assets which may be more appropriate to the estate portfolio than the stock of a closely held corporation and, at the same time, fixing the estate taxes payable with respect to their stock at a manageable level. This goal is normally achieved by providing for the purchase of a shareholder’s stock at his death.

3. To establish and to assure the continuation of certain basic policies with respect to the operation of the corporation, especially in the significant areas of the payment of dividends and the election of officers and directors.

Although shareholders’ agreements frequently have other goals, these three basic goals are the most common, and the problems which hinder the
achievement of these basic goals are the ones with which the corporate lawyer is frequently faced when preparing a shareholders’ agreement.

One of the very first problems confronting the draftsmen of a shareholders’ agreement relates to the identity of the parties to the agreement, which can have serious effect upon the validity of the agreement. If the parties include all of the shareholders of the corporation, the validity of the agreement will probably be upheld, assuming no specific provision is invalid for other reasons and assuming the absence of fraud and duress. However, if less than all of the shareholders of the corporation are to be parties, the agreement’s validity can be jeopardized depending on the specific goals which it attempts to achieve. The courts traditionally have been suspicious of shareholders’ agreements involving less than all of a corporation’s shareholders because of the potential use of such agreements to abuse the rights of minority shareholders.

Although the mere fact that all shareholders are not parties should not by itself invalidate the agreement, this fact will limit the tools available to the draftsman in achieving the basic goals of the agreement. For example, such agreements may be vulnerable to attack by minority shareholders if they attempt to use the income or assets of the corporation to effect purchases of stock of parties to the agreement, particularly where the purchase price is excessive. Such an agreement may also be vulnerable if it attempts to affect ongoing corporate policy with respect to dividends, election of officers and directors, and the like, especially if such policies noticeably favor the parties to the agreement as opposed to shareholders who are not parties. The careful draftsman should, whenever possible, obtain the consent of non-party shareholders if implementation of any provision of the agreement could potentially have an effect adverse to their interests.

Another preliminary problem for the lawyer preparing a shareholders’ agreement can arise on an ethical level. In most cases, the lawyer representing the corporation will prepare the agreement as part of his responsibility as general corporate counsel. But in many situations, that lawyer

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2. The controversy concerning the general validity of shareholders’ agreements arises primarily in areas where the agreement seeks to pool or allocate the voting rights of the shareholders or to establish management policies for the corporation. The unanimity of a shareholders’ agreement removes many of the concerns which make agreements of this type potentially obnoxious. See generally F. O’Neal, Close Corporations § 5.24 (1971) [hereinafter cited as O’Neal]. Unanimity does not, however, prevent specific provisions of an agreement from being declared invalid where they transgress statutory provisions, violate common law rules or constitute or result in some breach of the fiduciary obligations among shareholders.


The tendency of the courts to sustain a unanimous shareholder agreement is, perhaps, due to the fact that there is less possibility that it will be used as an instrument of fraud or oppression against minority shareholders. On the other hand, agreements by holders of substantially all, but not all, the shares have given rise to conflicting judicial interpretations. Some courts regard them as invalid, whereas others treat them on the same basis as unanimous agreements. The trend of recent decisions is to disregard inconsequential holdings in determining the validity of shareholder agreements.

6 Z. Cavitch, Business Organizations § 114.01[1], at 3–4 (1975) [hereinafter cited as Cavitch].
of his firm also represents the individual shareholders with respect to their estate planning or other personal legal matters, so that the individual shareholders may not have independent personal counsel. In situations such as this, the lawyer preparing the agreement will find himself called upon to give advice not only as to which provisions of the agreement will be in the best interests of the corporation, but also as to how these provisions can benefit the shareholders as individuals. The inherent potential for conflict of interest in this situation is obvious.

Fortunately, the problem is often obviated by the fact that each shareholder, depending upon eventualities which cannot be foreseen at the time the agreement is being prepared, may ultimately be on either side of the transactions contemplated by the agreement. For example, in most cases, no shareholder will be able to anticipate, with respect to a provision calling for the purchase of the stock of a deceased shareholder, whether it will be his stock which will be purchased or whether he will be one of the surviving shareholders whose continuing efforts will be necessary to amortize the purchase price for the stock of one of his deceased associates. It is this uncertainty which provides the draftsman who "represents" all of the parties with the ability to objectively conceive and prepare the agreement without committing a breach of professional ethics.

However, in situations where the respective interests of the shareholders and the corporation under the proposed agreement are clearly diverse and potentially antagonistic, the parties should have independent representation. A good example of this latter situation is where, because of the respective ages or health of the shareholders, one of the shareholders is much more likely to predecease the others, thereby placing his interest in the buy-out provision in direct opposition to those of the corporation and the other shareholders.

In all cases, both to protect himself from potential professional liability and to orient the shareholders toward the attitude which will produce a fair agreement, the lawyer who is called upon to prepare a shareholders' agreement should at the outset make the shareholders aware that each of them may find himself on either side of a transaction contemplated by the agreement. This awareness will not only serve to crystalize any areas where diverse interests are present but, hopefully, will also instill in the shareholders the objective point of view which is vital to the preparation of an effective shareholders' agreement.

RESTRICTIONS ON THE ABILITY OF A SHAREHOLDER TO VOLUNTARILY TRANSFER HIS STOCK

Because one of the basic goals of shareholders' agreements is to prevent the intrusion of unwanted new shareholders, it is not surprising that the most common feature of an agreement among shareholders of a closely held corporation is a provision which attempts to restrict or limit the transferability of the stock owned by the parties to the agreement. Although the significance of these provisions is probably overemphasized in light of the
fact that shares of a closely held corporation are not readily marketable unless they represent a controlling interest, their use is nonetheless quite widespread. Provisions of this type vary widely in nature of the restrictions imposed but all must overcome one common legal obstacle—the rule, borrowed from the law of real property, that unreasonable restrictions upon alienation are unenforceable. Judicial interpretations as to the "reasonableness" of restrictions vary almost as widely as the types of restrictions employed, yet some basic conclusions can safely be drawn.

To begin with, it is certain that any absolute prohibition against transfer will fail, so that some form of partial restriction must be employed. The most common forms of partial restriction are those which require, as prerequisite to transfer, consent by the other shareholders who are party to the agreement and those which require a transferor to first subject the shares to be transferred to the options of other shareholders or the corporation itself. The first option restriction is generally held enforceable, provided the option price does not amount to a forfeiture. This type of restric-


5. The courts begin with the concept that a restraint can be valid if it is reasonably calculated to achieve a legitimate purpose. See Martin v. Graybar Elec. Co., 285 F.2d 619 (7th Cir. 1961). In order to determine legitimacy of purpose, the courts consider a number of factors, the most common of which are:

1. the size of the corporation;
2. the degree of restraint on the power to alienate;
3. the length of time the restriction is to remain in effect;
4. the method to be used in determining the transfer or option price of shares subject to the restraint;
5. the likelihood that the restriction will contribute to the attainment of corporate objectives;
6. the possibility that a hostile new shareholder would cause serious injury to the corporation;
7. the likelihood that the restraint will promote the interests of the corporate enterprise as a whole.

2 O'Neal § 7.06, at 18. In the context of a closely held corporation, factors (1), (5), (6) and (7) are almost automatically satisfied, leaving as the most significant factors those which deal with the nature of the restraint itself.


7. Other forms include requirements that the directors of the corporation consent to the transfer, prohibitions against transfers to specific classes of persons or restriction of transfers within such a specific class. 2 O'Neal § 7.05, at 8-9.

8. Beggy v. Deike, 413 Pa. 74, 196 A.2d 179 (1963); see Palmer v. Chamberlin, 191 F.2d 532 (5th Cir. 1951), and cases cited therein. See generally 6 CAVITCH § 114.02 [2]; 2 O'Neal § 7.09. Where the option price is equivalent to a forfeiture, a first option restriction can be tantamount to an absolute restraint. A good way to avoid the possibility of attack on the basis of the amount of the purchase price is to make the option price identical to that offered by the purchaser to whom the stock is proposed to be transferred. Care should be taken, however, to prevent the transferring shareholder from taking advantage of a collusive offer from a third party in order to obtain an inflated price for his stock. It should be noted that, in spite of the above considerations, a first option restraint requiring a tender of stock for $1.00 per share when the actual value was $1,060 per share or more was upheld as reasonable in re Mather's Estate, 410 Pa. 361, 189 A.2d 586 (1963).
tion is most often employed for this reason. More uncertainty clouds the enforceability of consent restrictions, however, because of the complete frustration of a proposed transfer which can result from a refusal to consent.\(^9\) While the exercise of first option restrictions simply substitutes the corporation or other shareholders as the purchaser of shares proposed for transfer, a refusal of consent poses a complete barrier to transfer. Therefore, the consent restraint is more vulnerable to an attack founded upon the favored policy of free alienation. This vulnerability becomes particularly acute where the restrictive provision requires the unanimous consent of the other shareholders, thus permitting a single shareholder to preclude a proposed transfer with what amounts to a veto. Although recent cases tend to recognize the validity of consent restrictions,\(^10\) controversy persists among the various jurisdictions as to their enforceability\(^11\) and, therefore, their use invites the prospect of litigation.

The Maryland cases are silent upon the question of enforceability of transfer restrictions imposed by agreement.\(^12\) Although it may be assumed that absolute restrictions are taboo, the choice between restrictions involving consent and those creating first options is not facilitated by any pertinent judicial ruling. Parallel authority with respect to consent restrictions is provided by the Maryland close corporation statute, which legislatively restricts transfers of stock in corporations incorporated under the act to those consented to by all other stockholders.\(^13\) Unfortunately, the legislative history underlying this statutory restriction\(^14\) does not resolve the dilemma faced by those interpreting the statute as to whether the legislature adopted the restrictions merely as a codification of common law or as an exception to a general common law rule which would otherwise invalidate restrictions of this type. The latter interpretation is supported by the fact

9. "Until about 1920, the courts here almost without exception held that any restriction conditioning the power of a shareholder to dispose of his shares on the consent of some other person was an invalid restraint on the alienability of the shares." 2 O'Neal §7.08, at 34.


12. A by-law restriction requiring a shareholder to submit his stock to the options of the other shareholders before transferring it to a third party has been declared invalid as "an unreasonable and palpable restraint upon the alienation of property." Victor G. Bloede Co. v. Bloede, 84 Md. 129, 141-42 (1896). It is unlikely, however, that this ruling would prevail today in light of the overwhelming modern authority to the contrary in other jurisdictions. In Cataldo, Stock Transfer Restrictions and the Closed Corporation, 37 Va. L. Rev. 229 (1951), the author stated that Bloede was the only case he could find in which first option restrictions were held invalid.

13. No transfer of the stock of a close corporation shall be valid unless: (1) such transfer has been consented to no more than three months prior to the date of the transfer by all stockholders of the corporation by a signed written instrument; or (2) such transfer is made pursuant to a provision of a stockholders' agreement authorized by Section 104 of this subtitle requiring the purchase of stock by, or the offer of stock to (i) the corporation, or (ii) one or more of its stockholders, or (iii) one or more persons named in such agreement.

that this statutory recognition of consent restrictions was enacted as an integral part of a special legislative scheme favoring small corporations and is not available to corporations not electing to be governed by all provisions of the act.

The only broad legislative mention of restrictions against transfer appears in Section 27(c) of the Maryland Corporation Law, which requires notice of any applicable restrictions on the face of stock certificates, and in Section 8-204 of the Uniform Commercial Code, which contains a similar requirement. The effect of these provisions is simply to prevent the enforcement of restrictions without proper notice against bona fide purchasers of the restricted shares. These sections fail to enlighten as to the underlying lawfulness of various restrictions, although their enactment implies that at least some types of restrictions are lawful.

Although restrictions on transferability are normally desirable, there are situations where a shareholders' agreement should permit unrestricted transfers of certain limited types. For example, a common estate planning device employed by shareholders who are conscious of heavy potential estate taxes is to remove assets from their estates by inter vivos gifts to the ultimate objects of their bounty. In many cases, the principal asset of the estate of a shareholder of a closely held corporation is the stock of that corporation. Consequently, to preserve this estate planning alternative, shareholders' agreements often permit, as exceptions to the provisions

15. Compare the recently enacted provision of the Del. Code Ann. § 8-202 (1967), which specifically recognizes as valid several different forms of restriction, including first option restrictions, consent restrictions, mandatory purchase restrictions, restrictions prohibiting transfers to certain persons or classes of persons (if the designation of persons or classes is not "manifestly unreasonable"), and "any other lawful restriction on transfer." This statutory provision applies to all corporations under Delaware's General Corporation Law.

16. Every certificate representing shares which are restricted or limited as to transferability by the corporation issuing such shares shall either (i) set forth upon the face or back of the certificate a full statement of such restriction or limitation or (ii) state that the corporation will furnish such a statement upon request and without charge to any holder of such shares. Nothing in this paragraph shall be deemed to affect the provisions of Section 8-204 of Article 95B.

17. Unless conspicuously noted on the security, a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it.

18. Although the statutory language implies that restrictions may be valid and enforceable, the following clarification is made:

The present section in no way laters the prevailing case law which recognizes free alienability as an inherent attribute of securities and holds invalid unreasonable restraints on alienation.
restricting transferability, inter vivos transfers of stock to a shareholder's spouse, children, grandchildren or other close relatives or to trusts for the benefit of these relatives. Similarly, it is not uncommon that a shareholder may have a relative who is active in the business and who is acceptable to the other shareholders as a successor to that shareholder's ownership interest. Here again, it is usually desirable for the transfer restrictions of a shareholders' agreement to except transfers to such a relative.

Where exceptions of this type are employed, care should be taken that the permitted transfers do not frustrate the basic goals of the agreement. For example, if an agreement requires the purchase of shareholder's stock at his death, any provision permitting inter vivos transfers for estate planning purposes should require the purchase of all shares held by the transferee upon the death of the transferring shareholder. Otherwise, the remaining shareholders will be forced to effect a purchase of the stock of the deceased shareholder, but will be obliged to continue to include his donees in the shareholder group. Further, each permitted transferee should be subjected to the same transfer restrictions as the original shareholders so that a permitted transfer will not indirectly result in a circumvention of the desired restrictions. Because it may not be possible to enforce the applicable provisions against a permitted transferee who is not party to the agreement, it is wise to require, as a condition precedent to a permitted transfer, that such transferee become a signatory to the agreement.19

RETRIEVAL OF STOCK INVOLUNTARILY PASSING OUT OF THE SHAREHOLDER GROUP

While transfer restrictions are normally sufficient to prevent voluntary transfers of stock to outsiders, an entirely different problem is posed by the prospect of shares changing hands on an involuntary basis. The events which can cause such an involuntary transfer are numerous. The shares which are pledged as collateral for personal loans to a shareholder can be sold or retained by lenders in the event of the shareholder's default. A shareholder can become the object of bankruptcy or insolvency proceedings which may pass his personal assets to a receiver or trustee in bankruptcy. The shares of a disabled or incompetent shareholder can become subject to the control of his guardian. Finally, the death of a shareholder will cause his shares to come under the control of his personal representatives and, ultimately, to pass to his legatees. In each of these cases, the result is the same, the remaining shareholders will be obliged to deal with an outsider when formulating corporate policy subsequent to the transfer. Of course, the significance of this result varies with the size of the stockholdings which are involuntarily transferred, but in the case of most closely held corporations, involuntary transfers can cause significant management difficulties.

19. In Matthews v. United States, 226 F. Supp. 1003 (E.D.N.Y. 1964), the court indicated that the restrictions imposed by the shareholders' agreement involved in that case applied to permitted transferees with notice in spite of the absence of a clause specifically binding them, because a contrary holding would frustrate the "critical function" of the agreement. However, a specific provision binding permitted transferees remains the more prudent alternative.
To assure the basic purpose of continuity in the shareholder group, the shareholders' agreement must provide some contractual method for the retrieval of stock which has passed out of the shareholder group by reason of one of the events described above. In most cases, the appropriate contractual method is that which is also employed to restrict voluntary transfers, that is, to provide the corporation or the other shareholders with options to purchase involuntarily transferred stock. However, the involuntary nature of the transfer can cause special problems which do not arise in the voluntary transfer situation. The first problem stems from the fact that the transfer will usually occur prior to the implementation of the option provisions. As a result, the party exercising option rights, whether corporation or shareholder, will be faced with the prospect of enforcing the option against the transferee. In most cases, the transferee will be bound if the certificates are properly legended to provide notice of the options. However, where the transferee is a trustee in bankruptcy, the power of the trustee to disavow executory contracts\(^2\) can pose a serious obstacle to the enforcement of the option provision.

Some draftsmen try to circumvent this latter problem by providing in the agreement that the stock of a bankrupt or insolvent shareholder shall be deemed automatically purchased by the corporation or the shareholders at some time prior to the institution of bankruptcy proceedings. Although the validity of such a provision is questionable because of the retrospective nature of its application, a provision of this type appears to be the only contractual method for avoiding the disavowal problem. On a more practical level, the most effective way to ensure the retrieval of shares from a trustee in bankruptcy is to provide for an option price which will enable the trustee to realize fair value for the shares on terms which are favorable from the point of view of satisfying the claims of the bankrupt shareholder's creditors. The efficacy of this practical safeguard is reinforced by the fact, mentioned earlier,\(^2\) that shares of stock of a closely held corporation are not readily marketable unless they represent majority control, so that a trustee in bankruptcy will normally be more than happy to honor an option provision containing a reasonable purchase price and favorable payment terms.

The possibility of an involuntary transfer of pledged stock in the event of default on the underlying debt can be avoided in the first instance by a provision restricting a shareholder's ability to pledge his stock. Although an absolute prohibition against a pledge of stock could constitute an unreasonable restraint,\(^2\) the use of first option provisions would seem permissible. Some form of partial restraint on the ability to pledge, such as a limit on the portion of a shareholder's shares which can be pledged or a maximum restriction on the size of the underlying loan, can also be effective. This

\(^2\) The trustee shall assume or reject an executory contract, including an unexpired lease or real property, within sixty days after the adjudication or within thirty days after the qualification of the trustee, whichever is later, but the court may for cause shown extend or reduce the time. . . .


22. Id. p. 215 supra; O'Neal § 7.05a.
latter alternative would appear particularly attractive from the shareholders’ point of view, since it would permit them to enjoy some economic benefit from their shares during their lifetimes. In reality, however, shares of a closely held corporation, unless they represent majority control, are not often accepted as collateral by lending institutions, so that a restriction on the ability to pledge will not be onerous in most situations.

Another problem arises in corporations in which all shareholders serve actively as employees. In such a situation, the permanent disability, resignation or retirement of a shareholder may cause problems with respect to the continuity of management quite similar to those caused by stock passing into the hands of an outsider. Problems of this nature are most likely to arise in service businesses where the active participation of each shareholder in the business contributes to the level of corporate income. The shareholders who continue to participate will naturally be reluctant to see the fruits of their efforts continue to inure to the benefit of the shareholder who, because of his resignation, retirement or disability, can no longer contribute to corporate growth. Even in businesses which are not service oriented, the retirement, resignation or permanent disability of a shareholder immediately puts his interests potentially at odds with those of the shareholders who continue to participate. For example, the shareholder who is no longer active will not fully participate in compensation and may begin to view his stock as a potential income producing asset, while the shareholders who remain active may be reluctant to distribute large portions of the corporation’s earnings in the form of dividends.

Although the divisive potential of this situation can be limited by carefully planned deferred compensation arrangements and disability wage continuation programs, the most foolproof method for avoiding the inherent problems caused by the retirement, resignation or permanent disability of a shareholder is to provide in the shareholders’ agreement for a purchase of his shares, either on a mandatory or optional basis. However, mandatory buy-out provisions can be troublesome if triggered by the resignation of a shareholder, since they permit a shareholder to force a purchase of his stock at a time when the valuation provisions of the agreement will yield the highest purchase price. Additionally, the shareholders may find it obnoxious that a resigning shareholder can force a purchase of his stock and

24. Where permanent disability or retirement are to be triggering events, these terms should be defined carefully to insure that the mandatory provisions operate fairly.
25. This problem would not arise where the purchase price under the agreement was fixed at an unchanging figure. See pp. 224-34 infra.
use the proceeds to finance a competing business. In such circumstances, an optional purchase may be appropriate.

PROVISIONS DEALING WITH CORPORATE ORGANIZATION AND MANAGEMENT

At some stage in the development of a corporation, normally at or just prior to its organization, the shareholders may wish to make certain agreements among themselves to assure the establishment and continuity of specific corporate policies. Although as a group the shareholders can continuously assure such policies through their control of the board of directors, such an agreement is often desirable from the point of view of a minority shareholder to prevent a majority shareholder, or a combination of shareholders constituting a majority, from departing from the desired policies or from adopting new policies contrary to the interest of the minority. Agreements of this type are also useful when the shareholders are not familiar with one another and wish to negotiate and reach agreement concerning the prevailing corporate policies prior to incorporation.

When such an agreement is prepared prior to incorporation it can reflect the agreement of the contracting parties as to the terms to be included in the Articles of Incorporation and By-Laws of the corporation, such as the purposes of incorporation, the structure of the corporation's capitalization, the presence or absence of pre-emptive rights, the number of votes required for certain types of corporate action, the applicability of cumulative voting, the number of directors and the names of the initial directors, the corporation's fiscal year, the number, titles and duties of corporate officers and similar organizational matters. Initial agreement can also be reached with respect to the advisability of electing Subchapter S status or qualifying as a Maryland Close Corporation. Furthermore, such an initial agreement can contain provisions imposing transfer restrictions, death buy-out provisions and provisions dealing with other subject matter described elsewhere in this article. When used in this manner, the pre-incorporation agreement is an extremely useful planning tool simply because its negotiation and preparation forces the shareholders to focus upon and resolve many of the organizational problems of incorporation and avoids the tendency of most incorporators to employ canned forms as the basic corporate documents without giving careful thought to their contents.

The subject matter discussed thus far can be incorporated into shareholders' agreements without transgressing any legal boundaries other than those discussed previously. It is only when the agreement begins to treat matters which traditionally fall within the continuing discretion of the board of directors that legal problems can arise. These problems arise most

26. This prospect can be avoided, at least temporarily, by a noncompetition covenant having reasonable limitations as to time and territory.
27. See pp. 234-40 infra.
frequently when shareholders seek by agreement to formulate lasting corporate policy in two areas which are, as a matter of basic corporate law, the perogative of the board of directors: (1) the selection, tenure and compensation of corporate officers; and (2) the formulation of dividend policy.

Although the validity of provisions in shareholders agreements which attempt to formulate lasting policies in these areas depend primarily upon the extent to which the discretion of the board of directors has been emasculated, it is clear that the prevailing judicial authorities will not permit total pre-emption of these areas by provisions in shareholders' agreements. Application of these authorities in the context of the closely held corporation appears inappropriate, since, in most cases, the shareholders will themselves be the directors and officers of the corporation. This reality has been recognized by the Maryland Close Corporation statute, which gives shareholders broad authority to formulate management policy within the confines of that statutory scheme. However, since corporations which do not elect close corporation status must still deal with the traditional authorities, draftsmen of shareholders' agreements for such corporations must be sensitive to the dangers of encroaching too extensively upon the domain of the board of directors.

PROVISIONS FOR THE PURCHASE OF STOCK UPON THE DEATH OF A SHAREHOLDER

As has already been illustrated, one of the prevailing goals of an agreement among shareholders is to keep the stock of the corporation, to the extent possible, in the hands of the existing shareholder group. Yet, one way in which stock can pass out of the favored shareholder group is through the operation of testamentary laws and instruments. For this reason, shareholders' agreements commonly provide a mechanism for the purchase of the shares of a deceased stockholder, either by the corporation itself or by the remaining shareholders.

From the standpoint of the individual shareholder, provisions of this type are normally quite attractive. One of the great ironies of our income tax laws is that the shareholders of a closely held corporation, and their lawyers and accountants, normally devote much of their time and ingenuity to devising methods by which a shareholder can extract cash from the corporation without having that cash seriously eroded by income taxes at both the corporate and shareholder levels and that probably the best of those methods become available only on his death. Most of these shareholders find that the amounts of cash which can be withdrawn in salaries, bonuses, rents, fringe benefits and other tax deductible forms which avoid the dreaded double tax are quite limited. They also find that

29. See 1 O'Neal § 5.16; 6 Cavitch § 114.03.
such cash-producing alternatives as sales of stock, redemptions, partial liquidations and complete liquidations also produce significant taxable capital gains primarily due to the low basis which most such shareholders have in their stock. Understandably, it is with some chagrin that a shareholder of a closely held corporation discovers, usually from his lawyer or accountant, that probably the best tax saving alternative that he has in this regard is to die.

This potential tax saving arises, of course, from the fact that, upon a shareholder’s death, his stock passes to his estate at a basis which equals its fair market value at the time of his death.\textsuperscript{31} Although estate taxes take their toll, the estate tax bite would certainly not approach the combined capital gain and estate tax burden which a deceased shareholder would have to pay had he sold his shares or had them redeemed prior to death.\textsuperscript{32} Once the shares have passed to a shareholder’s estate at this “stepped-up” basis, the prospect of an essentially tax free sale of those shares is extremely attractive. This is particularly true where the estate needs liquidity for the payment of death taxes, funeral expenses and administration costs. Since the market for such shares is, for all practical purposes, limited to the shareholder group and the corporation itself, the individual shareholder normally welcomes a contractual provision which provides such a market.

In structuring a death buy-out, the draftsman has three basic alternatives: he can give the corporation or the remaining shareholders options to purchase the stock; he can give the estate a “put” option which, if exercised, would require the corporation or the remaining shareholders to purchase the stock; or he can make the purchase mandatory upon both the estate and the purchasing party. The purchasing party will want the flexibility afforded by a purchase option and the shareholder will favor the “put” option for similar reasons. Consequently, mandatory provisions are resorted to in most situations by way of compromise, since provisions of the mandatory variety provide the corporation and the shareholders with assured continuity of management and interest and afford each shareholder with a guaranteed market for his shares after death.

Another tax advantage of a death buy-out provision is that it can, if properly conceived, establish the maximum value of the deceased shareholder’s stock for federal estate tax purposes. Although the Internal Revenue Code and the regulations thereunder do not specifically so provide,\textsuperscript{33} a number of cases have held that the contractual obligation of an estate to sell the decedent’s stock to the corporation or the surviving

\textsuperscript{31} Int. Rev. Code of 1954, § 1014.

\textsuperscript{32} If the shares were redeemed or sold prior to death, the shareholder would be subjected both to capital gains tax on his gain at the time of the transaction and to estate taxes on the reinvested proceeds of the transaction upon his subsequent demise.

\textsuperscript{33} See Int. Rev. Code of 1954, § 2031; Treas. Reg. § 20.2031-2 (1962). However, Treas. Reg. 20.2031-2(h) (1962) does provide that the price set forth in an agreement providing for a mandatory purchase of stock from the estate is one of the factors to be considered in establishing the value of that stock for estate tax purposes.
shareholders for a bona fide purchase price will cause the maximum estate tax value of that stock to be the contractual purchase price.\textsuperscript{34} The theory of these cases is that the Internal Revenue Service cannot assess the stock at a value higher than the contractual price because the estate cannot avail itself of any market for the stock other than the contractual purchaser. Using this theory, other cases have held that a mandatory death buy-out provision will not fix the maximum estate tax value if the decedent, prior to his death, could have disposed of his stock at a price greater than that provided for in the agreement.\textsuperscript{35} Accordingly, inter vivos restrictions on transfer must complement the death buy-out provisions if this important tax benefit is to be attained.

Where the complete purchase or redemption of stock of a deceased shareholder is not appropriate, because of the particular situation, but a need for cash in the shareholder’s estate is anticipated, the shareholders’ agreement can require the corporation to effect a redemption of stock held by the shareholder’s estate in amounts necessary to pay the death related expenses and taxes described in Section 303 of the Internal Revenue Code. A redemption of this type can, if Section 303 is applicable, be accomplished without fear that it will be deemed by the Internal Revenue Service to be substantially equivalent to a dividend, because Section 303 provides a safe harbor from the dividend attack for redemptions which come within its ambit.\textsuperscript{36} A provision requiring the corporation to effect a Section 303 redemption can be particularly useful where the corporation and the remaining shareholders are financially unable to effect a complete purchase of the deceased shareholder’s interest, where the shareholders wish to make testamentary transfers of portions of their stock to children or relatives working in the business or where a purchase of all shares of a deceased shareholder’s stock is not appropriate for some other reason.\textsuperscript{37}

PROVISIONS FOR COMPUTING AND PAYING PURCHASE PRICE

Whether as a result of first option provisions being triggered by proposed voluntary or actual involuntary transfers or as a result of mandatory or optional purchases arising upon a shareholder’s death, the draftsman of a shareholders’ agreement may be faced with the task of interpreting and implementing the provisions of his agreement dealing with the computation

\textsuperscript{34} Fidelity Bank & Trust Co. v. United States, 209 F. Supp. 254 (W.D. Ky. 1962); Estate of O.B. Littick, 31 T.C. 181 (1958). If the price established by the contractual provision is not bona fide, it will be ignored for purposes of establishing estate tax value. Treas. Reg. \textsuperscript{39} § 20.2031-2(h) (1963).

\textsuperscript{35} See, e.g., Estate of J.H. Matthews, 3 T.C. 525 (1944); Claire Giannini Hoffman, 2 T.C. 1160 (1943), aff’d, 148 F.2d 285 (9th Cir.), cert. denied 326 U.S. 730 (1945).

\textsuperscript{36} INT. REV. CODE OF 1954, § 303(a). The safe harbor from dividend treatment applies only to the extent that the redemption price does not exceed the sum of “the estate, inheritance, legacy and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent’s death,” id. § 303(a)(1) and “the amount of funeral and administration expenses allowable as deductions to the estate,” id. § 303(a)(2). In addition, the stock of the corporation must comprise more than 35% of the decedent’s gross estate or more than 50% of his taxable estate if § 303 is to apply. Id. § 303(b)(2).

\textsuperscript{37} See pp. 241-43 infra.
and payment of the price at which stock will be purchased. Sometimes this experience can be embarrassing.

Consider the plight of the attorney who drafted the shareholders’ agreement which became the subject of dispute in *The Land and Simmons Co. v. Arconti.* He had apparently satisfied himself in drafting the contract that the words “book value...at the time of his death” adequately defined the purchase price intended to be paid for a shareholder’s stock upon his demise. Imagine his shock when there developed a controversy concerning whether, pursuant to his language, the book value of the corporation should include the proceeds payable upon a shareholder’s death from insurance policies owned by the corporation covering his life. Imagine also the chagrin of a lawyer who learns of the death of one of the shareholders who is a party to a shareholders’ agreement which was prepared some time ago and, after consulting his copy of the agreement, discovers that the fixed purchase price which he had recommended is now far below the real value of the corporation’s stock, or that, even if the price is a fair one, the payment terms require installment payments which are beyond the financial capacity of the purchasing party.

These examples illustrate the problems which can arise when the purchase price provisions of a shareholders’ agreement are not carefully thought out and meticulously drafted. It is ironic that lawyers who are extremely careful in the conception and drafting of transfer restrictions and death buy-out provisions are content to permit the most significant provisions of the agreement, those dealing with purchase price and payment thereof, to speak loosely in terms of “book value,” “annual installments,” and the like.

The drafting of these crucial sections of a shareholders’ agreement should be preceded by a thorough analysis of the financial statements of the corporation and intensive discussions with its shareholders as to their conceptions of the value of their stock. These activities should be directed at producing concrete answers to the following questions:

1. What approach to the valuation of the corporation’s stock most accurately reflects the value of the underlying business?

2. How can the valuation approach best provide the flexibility necessary to adjust to the projected growth or deterioration of the business of the corporation?

3. What will be the source of funds from which the purchase price will be paid and, if portions of the purchase price are to be deferred, what level of installment payments will permit the selling party to receive the purchase price with reasonable promptness and still will allow the purchasing party to fulfill its installment obligation without financial hardship?

4. Based upon the business realities at hand and the pertinent income tax consequences, which party or parties should effect the purchase?

5. Within the context of the valuation approach ultimately chosen, what assets or liabilities of the business, if any, deserve special treatment?

38. 223 Md. 204, 162 A.2d 478 (1960).
6. If a portion of the purchase price is deferred, what security, if any, should be provided to assure the seller that the deferred portion will be paid and what rate of interest should the purchasing party be required to pay in return for the seller's willingness to defer receipt of the balance of the price for his stock?

Most of these questions are not unique to the shareholders' agreement but reflect the basic thinking which must be devoted to any agreement for the purchase of stock. The fundamental distinction, and the factor which makes valuation a more difficult process in the drafting of shareholders' agreements, is that most purchases of stock require the determination of a fair purchase price at the present, while the shareholders' agreement must provide for that same determination with respect to points of time in the future.

Although the various considerations in preparing the purchase price provisions are interrelated and often interdependent, the initial problem normally is to arrive at the method of valuation which will produce, at any given future time, the purchase price that best reflects the value of the underlying business at that point in time.39 Usually, the method selected will depend upon the nature of the business involved. For example, an approach based upon book value most often will not be appropriate by itself to reflect the value of a service business having few operating assets. On the other hand, a multiple of earnings approach by itself cannot accurately measure the worth of a corporation which owns significant tangible assets but which produces a low margin of net income from its operations.

In certain cases, the inapplicability of any of the accepted and traditional valuation methods will necessitate the use of a fixed purchase price stated in dollars with which the shareholders feel comfortable. However, a fixed dollar price should be used with caution because of the lack of flexibility which is inherent in such an approach. Where a fixed price is stipulated, fluctuations in the financial condition of the company over time can result in serious inequities. Although the possibility for such inequities can be limited by a requirement in the agreement that the purchase price be reviewed every year, difficulties still can ensue.

To begin with, should a disagreement arise among the parties to the agreement as to a subsequent revaluation, the validity of the agreement itself could be impaired and the goals of the agreement thereby frustrated. Second, if no revaluation occurs because of the inertia of the parties, and the fixed dollar value becomes unrealistic because of subsequent growth or deterioration, the party disadvantaged may have a basis for rescinding or cancelling the agreement. The disadvantaged party may argue that the re-evaluation process was a condition of the obligations of the parties under the agreement and those obligations were relieved by the fact that no revaluation was accomplished. Although such an argument can be foreclosed at the outset by a clause which specifies that failure to revalue

39. See generally Butala, Valuation of Closely Held Corporations, 7 INST. EST. PLAN. ¶ 73.1400 (1973), for a discussion of the valuation techniques frequently employed.
will not affect the basic obligations of the parties under the agreement, this solution does not address the basic inequity which may result if no revaluation is performed.

The disadvantaged party may also base his claim for rescission or cancellation upon the theories espoused in *Helms v. Duckworth*.\(^4\) The *Helms* case involved an attempt by the administratrix of the estate of a deceased shareholder to cancel a stock purchase agreement which would require her to sell the decedent's stock to the other stockholder of the corporation at a fixed price which, although fair at the time the agreement was executed, was far below the value of the stock at the time of decedent's death. The agreement contained a provision which permitted an annual redetermination of the purchase price upon the agreement of both parties, but neither party had requested a redetermination in accordance with that provision. The administratrix successfully argued that the surviving shareholder, who was much younger than decedent, had never intended to consent to a redetermination and that his misrepresentation of his intent to do so, as evidenced by the appearance of redetermination provisions in the contract, constituted a breach of the fiduciary duty owed by the survivor to the decedent.

Although *Helms* involved certain factual peculiarities which led the court to its recognition of the survivor's fiduciary transgressions,\(^4\) the court's endorsement of the application of fiduciary principles to the renegotiation of a fixed purchase price in a shareholders' agreement should give draftsmen sufficient cause to avoid fixed price provisions wherever possible. Quite significant here is the court's judgment that the survivor had breached fiduciary duties even though the decedent had never requested a redetermination pursuant to the agreement.\(^4\)\(^1\) This, together with the court's emphasis on the survivor's subjective intention not to agree to a redetermination, even if it had been requested, creates the implication that the *Helms* rationale would require a shareholder to initiate redetermination negotiations even in situations where those negotiations would certainly result in his obligation to pay a greater purchase price. While *Helms* probably reached a fair result based on the peculiar facts involved, it created a rationale which, when logically extended, could require conduct above and beyond the call of fiduciary duty.

\(^4\)^249 F.2d 482 (D.D.C. 1957).
\(^4\)^1 The surviving shareholder had admitted that he had never had any intention of agreeing to the revaluation of the stock under the agreement. The court found that the survivor had been under a duty to disclose this intention at the time of the execution of the contract. If the deceased shareholder had known of this intention at that time, the court reasoned, he might have refused to execute the agreement or insisted on some other method for computing purchase price which would be less subject to frustration by bad faith.
\(^4\)\(^2\) Compare Krebs v. McDonald, 266 S.W.2d 87 (Ky. 1953), in which the court ruled that the widow of a deceased shareholder could not complain about the valuation method under an agreement whereby the remaining shareholders had the right to purchase the deceased shareholder's stock, where the deceased shareholder had never objected to the method during the twenty years the agreement had been in existence; *In re Mather's Estate*, 410 Pa. 361, 189 A.2d 586 (1963), in which specific performance was granted under an agreement requiring a tender of stock at $1.00 per share when the real value of the stock was at least $1,060.
The inequities which can result from a fixed purchase price and the implications raised by *Helms* militate strongly in favor of a valuation approach which automatically adjusts the purchase price in proportion to changes in the fortunes of the business. One such approach is the concept of book value, the traditional standard for valuing small businesses. Book value is normally defined as the difference between a corporation's assets and its liabilities at a given point in time, as evidenced by the corporation's books of account or by its balance sheet prepared as of that point in time, and it represents basically the amount which the corporation's shareholders could expect to receive if the corporation were liquidated at that point in time, assuming the fair market value of its assets are properly reflected on its books. While this concept appears quite simple, a number of problems can arise where the book value approach is employed. One of these problems concerns the timing of a determination based on book value. Because book value is a balance sheet concept, representing a particular point in time, it is extremely important that the desired point in time be carefully chosen. The significance of this factor is clearly illustrated by the question raised in *The Land & Simmons Co. v. Arconti*.

In *Arconti*, the court was required to decide whether the price of the stock of a deceased shareholder pursuant to an agreement requiring the purchase of such stock at its "book value...at the time of his death" should include a pro rata portion of the proceeds of life insurance owned by the corporation on the deceased shareholder's life. The court found that such proceeds should be included in the book value of the corporation for purposes of computing the purchase price because the corporation became entitled to receive such proceeds at the time of the shareholder's death. Normally, corporate owned insurance on the lives of the shareholders is purchased in order to provide the corporation with funds to finance a death buy-out at a purchase price which does not include the proceeds of that insurance. If the use of insurance as a funding mechanism was intended by the parties to the *Arconti* agreement, that intent was frustrated by careless draftsmanship. If book value in the *Arconti* case had been computed as of a point in time prior to the deceased shareholder's death, the proceeds would clearly not have been a part of the corporation's book value, but any cash surrender value of the insurance would have been so included. The same result could have been reached by the use of a short clause excluding the insurance proceeds from the corporation's assets in determining book value. In any case, the careful draftsman would have clearly resolved the *Arconti* dilemma one way or the other.

In most situations where a book value approach is used to compute the purchase price in a shareholders' agreement, it is desirable that book value

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43. Once the corporation's book value has been determined, the book value of the share held by each shareholder is computed according to the proportions at which their respective shares would participate in the corporations assets at liquidation. For example, if all stock was common stock of one class, the book value of each share could be arrived at by dividing the total number of issued and outstanding shares into the book value of the corporation as a whole. If preferred stock is outstanding, the par value of the preferred stock is subtracted prior to the allocation of book value to common stock.
be measured as of a point in time which is reasonably close to the event which triggers the purchase. This practice limits the amount of fluctuation which may occur in book value between the time of valuation and the event resulting in a purchase. Often it is convenient and economical to determine book value as of the nearest date, prior or subsequent to the triggering event, for which financial statements will be available pursuant to normal corporate practices. Where monthly or quarterly statements are a common practice, such timing affords little danger of fluctuation. But, where statements are prepared only on an annual basis, it is possible for significant periods to intervene between the triggering event and the valuation date, thereby increasing the possibility for a significant change in book value during that interval. In the latter case, the increased danger of fluctuation probably is not justified by the relatively minor savings in effort and accounting expenses which would be realized.

Before the draftsman can be satisfied with book value as his exclusive valuation concept, he must examine the financial statements of the corporation to make certain the value of the corporation's assets as stated therein fairly represents their market value. In many cases, the corporation may own real estate or other property which has appreciated in value substantially since its acquisition, but which is carried on the books at its acquisition cost less any available depreciation. Where this is the case, book value can be adjusted in the agreement to reflect the fair market value of such appreciated property by substituting the results of an appraisal of that property, conducted as of the valuation date, for its book value as of that date. Similarly, any marketable securities owned by the corporation normally should be valued at their market values rather than their book value. The draftsman should also explore the methods of depreciation being used by the corporation to determine if the book value of any depreciable asset is below fair market value as a result of the use of accelerated depreciation methods. Where this has occurred, an adjustment to the reserve for depreciation applicable to each such asset can be made in the agreement to show the value of the assets less depreciation on a straight-line basis or such other basis as may be appropriate. If the corporation has set up on its books as liabilities reserves for future contingencies which may not occur, an adjustment causing such reserves to revert to surplus may also be appropriate. Although good will is automatically ignored if a book value approach is used, unless the corporation is carrying a good will entry on its books from a prior acquisition of a going business or for some other reason, it often adds clarity to the valuation process to add a clause expressly excluding good will, except such good will as may already be carried on the books. Also for purposes of clarity, a clause specifying the treatment of insurance proceeds on the life of a deceased shareholder is advisable, even though the desired treatment may appear indicated by the fixing of the valuation date.44

A second valuation method which provides desirable flexibility is the earnings method. While the book value approach basically reflects the re-

44. Such a clause would have avoided the problem in Arconti.
turn which a shareholder would realize upon a liquidation of the corporation, the valuation of a business based upon its production of earnings, conceptually at least, is more representative of its value to the shareholder as an ongoing enterprise. Valuation of a corporation's stock on the basis of earnings normally involves two steps: first, some method must be arrived at for determining the level of earnings which fairly represents the corporation's actual earnings potential; second, the parties must agree upon a multiple which, when applied to this representative level of corporate earnings, will provide a selling shareholder with a fair return for his relinquishment of future participation in those earnings upon the sale of his stock. Once these steps are complete, the computation of the purchase price for each share of stock is a simple arithmetic exercise; however, both steps entail special problems.

The most accurate level of earnings for purposes of the future valuation of stock is, in most cases, an average of earnings for several years prior to the date of valuation. The use of an average level of earnings, as opposed to the level of earnings for a single year, is especially appropriate in the small corporation because of the propensity of smaller businesses to have fluctuating earnings from year to year. Where a business historically has shown a distinct upward or downward trend in its earnings, an average of earnings weighted in favor of the most recent years preceding sale may be more accurate.

In fixing a fair method for determining a representative earnings level, it is quite important that earnings be carefully defined. Earnings are normally defined in terms of the amount of income which is available, after the appropriate deduction for federal, state and local corporate income taxes, for the payment of dividends or for use within the corporation. So that the definition of earnings more fairly depicts the result of operations, certain adjustments are often appropriate.

The first type of adjustment takes into account the reality, common in many closely held corporations, that the shareholders of the corporation are also its principal employees and that their compensation is often greater than the compensation which would be required to retain an outsider to perform comparable employment obligations. Where this reality exists, some downward adjustment in the compensation of shareholder-employees is necessary if the definition of earnings is to accurately reflect the earnings potential of the business. Where fixed assets are written off pursuant to an accelerated method of depreciation, an adjustment to provide for depreciation on a straight-line basis is usually desirable to produce an accurate earnings picture. Adjustment should also be made for income or loss which results from extraordinary transactions, such as the sale of capital assets, which are extraneous to normal business operations. In situations where operating assets are owned by the shareholders individually or by an affiliated partnership or corporation, and leased to the corporation, the rents paid by the corporation pursuant to these lease arrangements, which are a deduction from earnings, should be carefully examined to determine whether they correspond to rates of rental at which such assets could be
leased on the open market. If such rates do not correspond with market rentals they can be adjusted to avoid distortions in the earnings picture. Other transactions between the corporation and its shareholders or affiliated entities should also be scrutinized to determine whether adjustment is necessary or appropriate to an objective definition of the earnings of the corporation.

After a satisfactory earnings level has been established, the parties to the agreement must strike upon an equally satisfactory multiple for capitalizing that earnings level to reach a final value upon which the purchase price will be based. This final factor is highly intangible. Theoretically, the capitalization factor should be the product of the shareholders' desired rate of annual return on their investment. As a practical matter, however, the capitalization multiple will depend upon the subjective expectations of the shareholders as to the prospect of continued future earnings; if the probability of continued earnings is considered high, the multiple will be correspondingly high, and vice versa. Thus, the determination of the appropriate multiple will depend upon the result of negotiations among the parties to the agreement as to the reliability of projected corporate earnings.

The two fundamental methods of valuation are by no means mutually exclusive, and a combination of the two methods is frequently employed. Conceptually at least, a reasonable price would seem to be one which gives the shareholder compensation both for the value which a liquidation would produce and for the future earnings which he will relinquish. Consequently, in many situations, a book value approach can be properly complemented by an increment representing a factor of earnings.

In the final analysis, however, the various approaches to valuation for purposes of computing purchase price, although they are significant for purposes of providing flexibility in the future and for properly compensating the shareholders, must be reconciled with one very important factor—the ability of the purchasing party to come up with sufficient funds to pay the price which is agreed upon. Although steps can be taken to maximize funding, as will be illustrated later, the key to a successful purchase arrangement is to properly balance the desire of each shareholder to receive a fair price if his shares are purchased and his desire to effect a purchase of the shares of other shareholders without undue financial hardship to the corporation or the remaining shareholders.

One of the initial steps in maximizing the funding of a purchase is to select the proper purchasing party. In most situations, the parties to a shareholders' agreement have the option to name either the corporation or the remaining shareholders as the purchasing party. Unless the shareholders are persons having significant assets outside the corporation, the option is usually decided in favor of a corporate redemption of shares upon the occurrence of the triggering events. This is usually the case even where life insurance is used to fund purchase obligations, since cash will be required to pay premiums and, ultimately, to pay whatever portion of the purchase price is not covered by insurance. Further, even if life insurance funding is employed, the insurance proceeds would not be available if the triggering
event is some occurrence other than a shareholder's death. The cash produced by the corporation's operations is normally the most likely source of funds for the payment of life insurance premiums and for the payment of uninsured portions of purchase price. Although those funds could be distributed to the shareholders for the purpose of funding a cross-purchase arrangement among shareholders, their distribution would cause serious dilution of the amounts made so available since dividend treatment with its double tax bite would ensue. Because the corporation is the most likely source of funding and because it can use, for purposes of such funding, dollars which have been taxed only once, it is usually relied on in the close corporation context as the principal purchaser. Where more than two shareholders are involved, use of the corporation as the primary purchaser facilitates life insurance funding in that it avoids the maze of life insurance policies which would result in a cross-purchase arrangement. The corporation need own only one policy on each shareholder's life, while each shareholder in a cross-purchase agreement must own policies on the life of each other shareholder.

Use of the corporation as the sole purchasing party, however, has certain drawbacks. First, statutory restrictions can preclude or inhibit the ability of the corporation to ultimately effect the desired purchase. The restriction which causes the most difficulty is the statutory requirement that shares cannot be purchased except out of surplus. Although the impact of the surplus restriction can be softened by a clause in the agreement requiring the corporation and the remaining shareholders to reduce stated capital to create additional surplus if necessary or by the availability of life insurance to increase surplus where death is the triggering event, it nonetheless creates a finite limit for corporate purchases which can frustrate the fundamental goals of the shareholders' agreement. The only sure solution to the surplus problem is the addition of the remaining shareholders as secondary purchasers of any shares which the corporation cannot purchase due to insufficient surplus.

The use of the remaining shareholders as secondary purchasers also provides greater flexibility to meet other special problems. For example, in the family owned business, the possibility that the purchase price will be treated as a dividend for tax purposes as a result of the application of the rules of attribution can be avoided by requiring the remaining shareholders to purchase all shares in excess of those which can be purchased without dividend consequences pursuant to Section 303 of the Internal Revenue Code. Where the first option method of transfer restriction is employed, giving secondary options to the remaining shareholders can maximize the alternatives available if the restriction must subsequently be enforced. For

45. If whole life insurance is used, however, the cash surrender value of the policies is available as funding assistance.
47. Id. § 32(b)(3).
48. See generally id. §§ 34–36, for the statutory requirements for reducing stated capital.
49. See pp. 242-43 infra.
50. See pp. 222-24 supra.
example, if a shareholder's proposed transfer to a third party triggers the option procedure at a time when funds are scarce at the corporate level, the secondary options of the shareholders can be employed to purchase all or part of stock proposed for transfer thereby keeping it within the existing shareholder group without causing serious financial hardship for the corporation.

Once the most appropriate purchasing party has been determined, the possible sources of funds available to that party for the payment of the purchase price must be explored. Few closely held corporations have sufficient cash to make payment in full for stock which is purchased pursuant to a shareholders' agreement without a fatal impairment of working capital. By the same token, few shareholders of such corporations have sufficient liquidity to effect such a cash buy-out. Two methods are used, normally in combination, to facilitate the funding process. The first method is the deferral of a substantial portion of the purchase price so that it can be paid in installments out of future earnings or income over a period of time. The second method is to purchase insurance on the lives of the shareholders. Although premiums paid by the corporation for insurance acquired to fund purchase obligations are not tax deductible, this drawback is more than outweighed by the availability of significant amounts of tax free proceeds to fund a death buy-out. While the life insurance method achieves its most dramatic results by making insurance proceeds available to fund a death buy-out, it can, through the use of whole life insurance, produce cash surrender values which, when withdrawn or borrowed against, can provide funding assistance on a more modest basis when the purchase is triggered by an event other than death.

These funding methods should not, however, be employed without careful consideration. The value of large amounts of life insurance proceeds as a source of funds must be weighed carefully against the ability of the purchasing party to pay the large premiums which are required to produce such substantial proceeds. By the same token, the attractiveness of a long pay-out period must be balanced against the natural desire of a selling shareholder to receive, or have his estate receive, the purchase price for his shares within a reasonable period of time, without serious erosion by inflation.

51. In employing the deferral method of funding, two tax considerations should be kept in mind. First, if interest on the deferred portion of the purchase price is charged at a rate less than 4% per annum, interest will be imputed at the rate of 5% per annum, thereby converting a portion of the purchase price to interest for income tax purposes. Inr. Rev. Code of 1954, § 483; Treas. Reg. § 1.483-1 (1966). This converted portion of the purchase price will be deductible to the purchaser and be ordinary income to the selling shareholder. Second, if more than 30% of the purchase price is paid during the calendar year in which the purchase occurred, the selling shareholder will not be able to report his gain on the installment basis and will be obliged to recognize the entire gain in the year of the purchase. Inr. Rev. Code of 1954, § 453. This latter consideration is normally not significant in purchases triggered by the death of a shareholder, since the increase in basis of the shares in the hands of his estate will result in little or no gain to the estate from the purchase.


53. See id. § 101(a).
The final problem in drafting provisions dealing with purchase price is to determine what, if any, security should be provided the selling shareholder, or his estate, to ensure payment of the deferred portion of the purchase price. The need for such security will vary depending upon a number of factors, including the financial stability of the business, the size of the deferred portion of the purchase price and the length of the pay-out period. The methods of providing security are those normally called upon to secure the repayment of third party loans made to small businesses, since the deferred portion of the price has, in economic terms, been borrowed from the selling shareholder or his estate.

The personal guarantees of the remaining shareholders are the simplest and most logical source of security where the corporation is the purchasing party, but shareholders who view themselves in the role of the survivors in a buy-out situation are often reluctant to increase their personal liability for corporate obligations. The assets of the corporation are potential collateral where the corporation is the purchaser, but in many cases these assets may already be encumbered by purchase money liens or general liens to secure working capital loans. Finally, the selling shareholder may be offered a security interest in the shares which have been purchased from him as collateral for the unpaid portion of the purchase price. Although these shares undoubtedly would be of little value in situations where a default in the payment of the deferred portion arose from the financial difficulty of the corporation, the voting power which they represent could be extremely valuable where non-payment results from bad faith on the part of the surviving shareholders. The choice of the proper method of securing the balance of the purchase price rests ultimately with the shareholders who are parties to the agreement.

SPECIAL SITUATIONS

The draftsman of a shareholders' agreement for a closely held corporation may encounter situations which raise special problems in the planning and drafting of a successful agreement. Unless these special problems can be recognized and properly dealt with, they can effect significant distortions which can substantially interfere with the basic purposes of the agreement.

Subchapter S Corporations

A corporation which has elected to be taxed as a "small business corporation" under Subchapter S of the Internal Revenue Code\textsuperscript{54} will, because of the application of the income tax rules unique to such a corporation, offer potential problems to the draftsman which he would not encounter with the conventional corporation.

The first such problem arises from the fact that, under the provisions of Subchapter S, individual shareholders can, by their unilateral act, cause

\textsuperscript{54} Id. §§ 1371-79.
the corporation to lose its Subchapter S status. A shareholder's grant of a single share of stock to a trust will, for example, result in disqualification. Likewise, a transfer of shares to a new shareholder who fails to consent to the election within a specified period of time following his receipt of the transferred shares will also cause automatic termination of Subchapter S status. A shareholder can also cause disqualification by transferring shares to a number of shareholders, thereby causing the total number of shareholders to exceed the statutory limit of 10. If a shareholder dies, the failure of his executors to consent to the corporation's Subchapter S election within the specified time will also result in termination.

The tax effect of such a unilateral termination can be drastic. The principal benefit of Subchapter S status is that cash can be withdrawn from the corporation in the form of dividends without the dreaded double tax effect, since the provisions of Subchapter S impose no tax at the corporate level, but tax all corporate earnings to its shareholders in basically the same manner as partnerships. Similarly, corporate losses can be offset against the personal income of its shareholders to the extent of their respective bases in their stock. Where Subchapter S status is terminated by one of the unilateral acts described above, the termination is retroactive to the beginning of the taxable year of the corporation in which the unilateral event occurred, so that dividend distributions made earlier in the year under the assumption that they would be taxed only once suddenly become retroactively double taxed, or conversely, corporate losses which were counted on to shelter shareholder income suddenly can be set off only against subsequent corporate income. This drastic effect is magnified when the unilateral terminating event occurs accidentally and the termination is not discovered until a tax return of the corporation is audited, perhaps years later. Once Subchapter S status has been terminated, the corporation cannot re-elect such status for five years, so that a unilateral termination has the additional effect of depriving the shareholders of Subchapter S benefits for a significant time in the future.

Further, the retroactive nature of the termination can cause accumulated corporate earnings from previous years, on which taxes have previously been paid by the shareholders, to be "locked-in", that is, distributable only upon payment of a second tax at the shareholder level. This previously taxed income can, with certain limitations, be distributed tax free at any time prior to 2½ months after the end of a corporation's last Subchapter S year; if such income is distributed after that period has expired, it can be treated like a normal corporate dividend and taxed again to the shareholders. Consequently, a unilateral act which occurs after the expiration of 2½ months of a taxable year, by causing termination

55. See id. § 1372(e); Treas. Reg. § 1.1372-4 (1969).
56. INT. REV. CODE OF 1954, § 1373.
57. Id. § 1374.
58. See id. §§ 1372(c)(1), (3).
59. Id. § 1372(f).
60. Id. § 1375(d); Treas. Reg. § 1.1375-4(a) (1968).
Thus, it is normally in the best interests of the parties to a shareholders’ agreement for a Subchapter S corporation to include provisions directed at preventing or punishing a shareholder’s unilateral act which will cause termination of Subchapter S status. Normal restrictions against transfer are not a sufficient deterrent since Subchapter S status can be terminated by a disqualifying transfer in violation of the restrictions, leaving the remaining shareholders and the corporation with the unenviable task of proving that loss of Subchapter S benefits are recoverable damages in a breach of contract action against the transgressing shareholder. For this reason, normal restrictions should be bolstered by provisions requiring the transgressing shareholder to indemnify the other shareholders for lost Subchapter S benefits caused by his unilateral disqualifying act. Further, the normal provisions calling for the purchase of the stock of a deceased shareholder do not prevent termination of Subchapter S status by his estate’s failure to consent, since those provisions cannot be implemented until after the estate has become a shareholder. Thus, the normal death provisions should be complemented by a provision directing the shareholder’s executors to execute a timely consent and requiring indemnity from the estate for their failure to do so.

It is also advisable to include a provision whereby the shareholders agree to abide by the decision of the corporation’s board of directors or the majority decision of the shareholders to voluntarily revoke the election. Because a voluntary revocation must be unanimously approved by the shareholders, the absence of such a provision could permit a single shareholder to veto a revocation dictated by sound tax planning considerations.

The application of Subchapter S can also cause distortions with respect to the purchase price computations of a shareholders’ agreement. One type of distortion arises from the requirement that all taxable corporate income of a Subchapter S corporation for a given fiscal year which is not distributed in the form of dividends during that year is taxed directly to the corporation’s shareholders in proportion to their stockholdings as of the last day of that fiscal year. In the event of a purchase by the corporation pursuant to the shareholders’ agreement, the shareholder whose shares are purchased will not be a shareholder of the corporation on the last day of the taxable year in which the purchase takes place, unless the closing by chance falls on that day. As a result, the outgoing shareholder as part of the purchase price will normally receive his share of the corporation’s earnings accumulated from the beginning of the year up to the date as of which the purchase price is computed, but he will not be subject to any income tax

61. INT. REV. CODE OF 1954, § 1372(e)(2).
62. Id. § 1373.
63. If the purchase price is based on book value, the earnings of the corporation to date will by definition be included in the purchase price.
on those earnings, except to the extent that he recognizes a capital gain from the transaction. Because undistributed income is not reduced under the Subchapter S rules by a distribution in redemption of stock, the outgoing shareholder’s share of these earnings will show up as undistributed income at the end of the year and the remaining shareholders, who will constitute the shareholders of the corporation at year end, will be subject to income tax thereon. Thus, the remaining shareholders will have “phantom income” in the year of redemption, that is, they will pay tax on income which was actually paid out to the outgoing shareholder in the form of purchase price.

This result is patently unfair to the remaining shareholders. The most effective way to avoid this result is to include a provision requiring the corporation to pay a dividend immediately prior to the purchase in an amount equal to the corporation’s estimated net earnings for the elapsed portion of the taxable year.64 This maneuver will have two results: (1) the outgoing shareholder will be subject to tax at ordinary income tax rates on the amount of the dividend received by him; and, (2) because the corporation’s undistributed income for the year will be automatically reduced by the amount of the dividend, the remaining shareholders will realize no “phantom income” at year end. However, there are practical difficulties implicit in this solution.

First, there is the obvious problem of accurately estimating the corporation’s net earnings as of the purchase date for the purpose of declaring the dividend. If the estimate is too low, the dividend will not completely offset the outgoing shareholder’s share of those net earnings, and the remaining shareholders may realize some phantom income at year end. On the other hand, if the estimate is high, the outgoing shareholder will get a greater share of the earnings than he would otherwise be entitled to. The only solution to this problem is to make the estimate as accurate as possible. Second, there is the risk that the payment of the dividend will deprive the corporation of cash needed to withstand the impact of operating losses which may occur later in the year.

A second purchase price problem caused by Subchapter S status arises from the concept of “previously taxed income” (“PTI”). The Subchapter S rules provide that the undistributed income of a “small business corporation” which is not distributed during the taxable year or within 2½ months thereafter, because it is taxed individually to the shareholders for that year, can be distributed tax free in later years provided certain prerequisites are met.65 For this reason, most Subchapter S corporations maintain bookkeeping accounts within their surplus account showing how much of this PTI has accumulated and in what proportions the shareholders of the corporation

64. This result would also be avoided by computing the purchase price as of the end of the previous taxable year. However, such a solution would either deprive the selling shareholder of his share of all corporate earnings for the period between the previous year-end and the date of purchase or permit him to avoid the effect of any corporate losses during such period.

share in these accumulations. Thus, each shareholder normally has his own PTI account. The amounts accumulated in these accounts are, in situations where the shareholdings of a corporation have been constant since the corporation's Subchapter S election, directly proportionate to shareholdings, and the computation of the book value of a shareholder's stock, when required by a purchase price clause of a shareholders' agreement, will incorporate his entire PTI account. However, where new stockholders have been added since the election was filed, the PTI accounts may not be proportionate to current shareholdings. Where this is the case, the purchase of the stock of one of the newer shareholders at book value, pursuant to a shareholders' agreement, will effectively give the newer shareholder an undeserved portion of the PTI accounts of the older shareholders unless some provision to the contrary is contained in the agreement. Such a provision could simply delete the PTI accounts as a whole from computation of book value and then add back into the purchase price the PTI account of the selling shareholder.

The PTI concept can result in yet another distortion caused by Subchapter S. In a book value buy-out of a living shareholder, his PTI account will be distributed to him as part of purchase price and will be taxed to him at capital gains rates to the extent the price exceeds his basis, in spite of the fact that his previously taxed income could have been distributed to him tax free had he continued to be a shareholder. Since the shareholder has already paid individual income taxes on the funds in the account, this additional capital gains tax represents a form of double tax on these funds. Unfortunately, there seems to be no practical way to avoid this result other than to provide, in the agreement, that all undistributed taxable income be distributed each year within 2½ months after year end, thereby precluding the accumulation of any previously taxed income.

Minor distortions can result in the Subchapter S situation where a period of time elapses between the date of valuation of stock for purposes of a book value buy-out and the date on which the purchase is actually closed. Usually, such an interval is provided to give the parties time to compute the purchase price or in the case of death to collect available life insurance proceeds and to provide time for the qualification of the executors of the deceased shareholder. If a year-end occurs during this interval, the selling shareholder, or his estate, will be a shareholder at year-end and, consequently, will be assessed with income taxes on his share of the undistributed taxable income for the year, including all such income which may accrue after the date on which the stock to be purchased has been valued. Conversely, where losses are incurred during this interval, the selling shareholder, or his estate, will be able to deduct those losses, but those

66. Because all distributions of income will have been proportionate to shareholdings, the PTI accounts would necessarily be proportionate.
67. If PTI could be distributed tax free at any time, this result could easily be avoided. However, Treas. Reg. § 1.1375-4(b) (1968) presumes that any distribution by the corporation is from current earnings and profits, effectively requiring the distribution of all current earnings and profits before tax-free distributions of PTI can be accomplished.
losses will not affect the value of the shares being purchased. While these distortions could be avoided by valuing the stock on the date the purchase is consummated, such a procedure is normally impractical because it does not provide sufficient time to accurately compute the purchase price. The best way to limit this distortion is to provide for a prompt consummation of the purchase, thereby avoiding the lapse of any significant period of time within which the distortions could become material.

A final observation concerning the Subchapter S corporation is that the direct taxation of corporate income to the shareholders of the corporation under Subchapter S eliminates one of the major considerations which normally militates in favor of employing the corporation as the primary purchaser of stock pursuant to a shareholders' agreement.68 In the conventional corporation, shareholders who are purchasers of stock must frequently use twice-taxed dollars to effect the purchase. Because all Subchapter S corporate income is only taxed once, it makes no difference whether the corporation purchases stock directly or the shareholders use their Subchapter S distributions to do so. The shareholder is taxed on the income in either case.

Further, the use of the corporation as the purchasing party in the Subchapter S context can result in a problem which is not directly related to the preparation of the agreement, but which can arise in the aftermath of the corporate redemption of a deceased shareholder which is funded by insurance proceeds received by the corporation as a result of the shareholder's death. As has been pointed out previously, the provisions of Subchapter S permit the tax-free distribution of undistributed income from prior years which has already been taxed to the shareholders pursuant to Subchapter S. However, such a distribution of previously taxed income is tax free to the recipient only if all of the earnings and profits for that fiscal year have been distributed in the form of dividends.69 Upon the corporation's receipt of insurance proceeds in the event of a shareholder's death, the corporation's earnings and profits for that year are increased by the amount of such proceeds.70 However, when the corporation pays out those proceeds as part of the redemption price for the deceased shareholder's stock, the earnings and profits for that year will decrease only to the extent of that portion of the redemption price which is not properly chargeable to the corporation's capital account.71 As a result, the transaction can cause a net increase in the earnings and profits for that year. This artificial net increase in earnings and profits for the year of redemption can effectively frustrate an attempted distribution of previously taxed income during that year, since the distribution of all current earnings from operations will not exhaust the artificially inflated earnings and profits. Thus, attempted distributions of previously taxed income during the redemption year, or

68. See pp. 232-33 supra.
69. See note 67 supra.
70. See Treas. Reg. § 1.312-6(b) (1955).
within 2½ months thereafter, can be rendered taxable to the extent of this artificially created excess in current earnings and profits. Accordingly, distributions of previously taxed income should be avoided during the year of a redemption or during the 2½ month period thereafter. Unfortunately, it is possible for a shareholder death to occur after a distribution of previously taxed income is made, but in the same fiscal year, thus retroactively destroying the tax free nature of the distribution. This result once again emphasizes the desirability of avoiding a buildup of previously taxed income by distributing all income to the shareholders on a current basis.

The Maryland Close Corporation

The Maryland Close Corporation Law,72 enacted in 1967, deserves specific mention here because of the special recognition which it gives to transfer restrictions and shareholders' agreements. This statute is probably best known for its provisions imposing stock transfer restrictions, which state that no transfer of stock by a shareholder of a corporation covered by the statute is valid unless written consent to the transfer has been obtained not more than three months prior to the transfer from all shareholders of the corporation or unless the transfer is provided for by a shareholders' agreement authorized by the statute.73 Although the restrictions are quite effective to invalidate voluntary transfers in violation of the consent requirement, they do not cover special situations for which restrictions are required to maintain the continuity of interest which is the ultimate goal of all transfer restrictions. For example, the word "transfer" as used in the restriction section does not include involuntary transfers to executors, administrators, trustees, receivers, guardians and the like, and does not include the creation of a security interest in stock which could ultimately result in a transfer. It also does not include the acquisition of a lien or power of sale over the stock of a close corporation. However, the restriction section does effectively preclude the stock from leaving the hands of persons who acquire it by virtue of transactions not covered by the definition of "transfer" by making any subsequent foreclosure or transfer by those persons a "transfer" for purposes of the restrictions. A careful draftsman will create special sections in a shareholders' agreement for this type of corporation to cover the situations not embraced by the "transfer" definition.74

One of the significant problems with the statutory transfer restriction of the close corporation law is that it permits a shareholder, or a person who acquired stock in a transaction not defined as a "transfer," to cause a dissolution of the corporation if consent to a proposed transfer is not forthcoming or if a transferee provided for in an authorized shareholders' agreement fails to live up to a purchase obligation. This dissolution right

73. Id. § 101.
74. See pp. 214-18 supra.
will arise “[u]nless otherwise provided by a stockholders’ agreement authorized by” the statute. Although the dissolution right is tempered by a provision in the statute permitting the other shareholders to purchase the shares of a shareholder who petitions for dissolution, the danger to all parties posed by the potential dissolution makes it advisable for the draftsman of a shareholders’ agreement for a close corporation to eliminate the right to dissolution by a specific provision in his agreement.

The section of the Close Corporation Law which specifically authorizes shareholders’ agreements goes beyond the limits imposed by the common law by granting broad authority to the shareholders to regulate and provide for virtually all of the situations at which such agreements are generally directed. Accordingly, it apparently eliminates much of the legal controversy surrounding the validity of shareholders’ agreements which attempt to intrude too extensively into the prerogative of corporate directors in the areas of management, election of officers, terms of employment of employees and dividend policy or which attempt to restrict or allocate the voting power of stock. In addition, this section makes a shareholders’ agreement authorized by its terms automatically binding upon subsequent shareholders with notice, thereby avoiding the necessity of renegotiating the agreement with the addition of every new shareholder.

The statutory transfer restrictions and the great flexibility in the acceptable purposes of shareholder agreements provided by the Close Corporation Law can, unfortunately, be availed of only at the cost of subjecting the corporation to the other provisions of the statute, many of which can be overly restrictive. For example, the flexibility of the corporation in raising capital is sharply limited by the requirement in the Close Corporation Law that no new stock may be issued without the unanimous consent of the shareholders. This limitation may, however, be qualified in a shareholders’ agreement authorized by the statute, and such qualification should be seriously considered by the draftsman of a close corporation shareholders’ agreement. The ability of a close corporation to avail itself of favorable opportunities to merge with or be acquired by another corporation is also severely limited by a requirement that approval of such an action by the shareholders must be unanimous. Unfortunately, the statute does not permit any qualification of this limitation in a shareholders’ agreement.

Constructive Dividends in Family Corporations

The first concern of any shareholder from whom shares of stock are being redeemed by a closely held corporation is whether the redemption distribution will be treated for income tax purposes as a sale or exchange giving rise

76. Id. § 109(c).
77. Id. § 104.
78. Id. § 102.
79. Id. § 110.
to capital gain or loss or as the equivalent of a dividend producing ordinary income. This question is governed by Section 302 of the Internal Revenue Code, which creates three basic tests for determining whether or not a redemption will be classified as a constructive dividend: first, if the redemption is not essentially equivalent to a dividend as a subjective matter, it will be treated as an exchange; second, redemptions which are substantially disproportionate with respect to the shareholdings of the corporation will be exempt from dividend treatment; and finally, a redemption which results in the complete termination of the shareholders' interest in the corporation will not be viewed as a dividend.  

These basic rules come into play in the context of shareholders' agreements where the agreement contemplates that the corporation will be the primary purchasing entity for purposes of death buy-outs, first option transfer restrictions and stock retrieval provisions. Under normal circumstances, dividend treatment is rarely a problem, since most redemptions pursuant to a shareholders' agreement will fall within the "termination of interest" or "substantially disproportionate" categories. However, special problems can arise where two or more of the shareholders are members of the same family or entities related to members of that family.

These special problems stem from the fact that, for purposes of Section 302, stock which is held by certain taxpayers who are related to the shareholder whose stock has been redeemed is "attributed" to that shareholder, so that he will be deemed to have owned such attributed stock when the "substantially disproportionate" and "termination of interest" tests are applied. These rules of attribution take two basic forms. The first type of attribution occurs between members of the same family, while the second takes place between certain entities and the persons directly interested in those entities.

The attribution of stock between related parties can have serious tax consequences to shareholders whose shares are redeemed pursuant to a shareholders' agreement. Redemptions under the first option or stock retrieval provisions of the agreement which would otherwise be substantially disproportionate or terminations of interest can be converted to potential constructive dividends by the attribution of additional stock to the redeemed shareholder from related shareholders. Further, attribution can prevent a death redemption from constituting a complete termination of the deceased shareholder's interest in the corporation. Thus the effect of attribution is often to remove a redemption transaction from the automatic exemptions from dividend treatment provided by the "substantially disproportionate" and "termination of interest" rules and force the redeemed shareholder to justify the capital nature of the transaction on the ground that it was not "essentially equivalent to a dividend." Because of the highly subjective nature of this standard, the draftsman should avoid

81. Id. § 318.
wherever possible situations which could result in reliance on this standard to avoid dividend treatment.\textsuperscript{82}

In cases where the family rules of attribution apply and where, but for the application of those rules, the redemption would constitute a complete termination of interest, the rules of attribution are waived if the redeemed shareholder retains no interest in the corporation, including an interest as an officer, director or employee, except as a creditor, and does not acquire an interest in the corporation within ten years after the redemption.\textsuperscript{83} To obtain this waiver, the redeemed shareholder must file with the Internal Revenue Service an agreement that he will notify the Service of any such reacquisition and that he will retain his records relating to the conditions of waiver. These waiver provisions apply only to the family rules of attribution, so that the entity rules of attribution can present an incurable barrier to a successful termination of interest redemption. In the case of a shareholders' agreement for a family corporation, the redemption of stock from the estate of a deceased shareholder can cause special problems where the deceased shareholder's children or spouse are beneficiaries of his estate as well as shareholders of the family corporation. In such a case, the stock of the beneficiaries will be attributed to the deceased shareholder's estate by virtue of the entity rules of attribution, which cannot be waived.\textsuperscript{84} In this situation, a logical alternative would be to have the corporation redeem the maximum number of shares exempted from dividend treatment under Section 303, and have the remaining shareholders purchase the balance.\textsuperscript{85}

\textsuperscript{82} Dividend treatment of a redemption from the estate of a deceased shareholder can be disastrous since it converts what would be an essentially tax-free transaction, because of the estate's stepped-up basis, into a fully taxable transaction, subject to ordinary income tax rates.

\textsuperscript{83} \textsc{Int. Rev. Code of 1954}, § 302(c)(2).

\textsuperscript{84} Until recently, the Service had taken the position that an estate or trust could not properly waive any attribution rules. See \textit{Rev. Rul. 59-233, 1959-2 CUM. BULL. 106; Rev. Rul. 72-472, 1972-2 CUM. BULL. 202}. However, the result in \textit{Lillian M. Crawford, 59 T.C. 830 (1973)}, has cast serious doubt on the validity of the Service's position. In \textit{Crawford}, a corporation redeemed, pursuant to the provisions of a shareholders' agreement, all of the stock held by a deceased shareholder's estate and all stock held personally by his wife, who was also the sole beneficiary of his estate. The sons of the deceased shareholder held the remaining stock of the corporation. The Service took the position that the redemption from the estate was essentially equivalent to a dividend because the stock held by the sons could be attributed to their mother and then to the estate, and because the estate could not waive attribution between the sons and the mother. The Service did not contest the right of the mother to waive attribution with respect to the redemption of the shares held personally by her. The court permitted the estate to successfully waive the \textit{family} attribution rules, recognizing that the estate could have avoided the problem by distributing the stock to the mother prior to redemption and having the mother waive attribution. As a matter of substance, the court observed, the mother had effected a complete termination of all her stock, including that to which she was entitled as beneficiary. The \textit{Crawford} holding still does not permit, however, waiver of entity rules of attribution in a situation in which the beneficiaries of an estate remain shareholders after the redemption. In any case, reliance on \textit{Crawford} should be tempered by the Service's nonacquiescence in 1974 \textsc{Int. Rev. Bull. No. 43}, at 11.

\textsuperscript{85} Of course, the estate plan of the deceased shareholder could cause his stock to pass in a testamentary fashion to his beneficiaries after consummation of the redemption under \textsc{Int. Rev. Code of 1954}, § 303.
If there is a lesson to be learned from the various problems which have been discussed in this article, it is that the shareholders’ agreement is both a valuable and complicated component of the planning process for closely held corporations. Because of its central role in the planning process, its preparation should be undertaken with the full awareness of the desired goals to be achieved by its provisions and the careful analysis of the potential problems incident to successfully attaining those goals. Each corporation will have different goals and different problems, so that reliance on a standard form of agreement for all close corporations is extremely unwise. If carefully conceived and meticulously drafted, a shareholders’ agreement can provide the backbone for corporate planning and the instrument for resolving many of the conflicting interests implicit in the relationship between the closely held corporation and its shareholders. If badly thought out and loosely drafted, a shareholders’ agreement can be the source of problems causing considerable pain for all concerned, including the draftsman. It is hoped that this article will stimulate a practical awareness of the potential problem areas inherent in the preparation of this special type of agreement and thereby obviate some of the hardship which can result from an unsuccessful agreement.