

LEGAL CONSIDERATIONS IN THE INCORPORATION PROCESS

Clinton Bristow, Jr.*

INTRODUCTION	60
I. SELECTION OF THE BUSINESS ENTITY	60
A. <i>Corporation v. Sole Proprietorship</i> ³³	60
B. <i>Corporation v. Partnership</i>	61
1. <i>Liability</i>	61
2. <i>Transferability of Interest</i>	63
3. <i>Access to Capital</i>	63
4. <i>Management</i>	63
5. <i>Tax Considerations</i>	63
II. PRE-INCORPORATION CONSIDERATIONS	65
A. <i>Preliminary Agreement</i>	65
B. <i>Pre-incorporation Subscription Agreements For The Issuance of Shares</i>	65
C. <i>Corporate Name</i>	66
D. <i>State of Incorporation</i>	67
III. CAPITAL STRUCTURE	68
A. <i>Stated Capital</i>	68
B. <i>Allocation of Interests</i>	68
C. <i>Thin Incorporation and Inadequate Capitalization</i>	69
D. <i>Section 1244 Small Business Stock</i>	70
E. <i>Loan Agreements</i>	71
IV. THE ARTICLES OF INCORPORATION	71
V. THE BY-LAWS	74
VI. SHAREHOLDERS AGREEMENTS	75
A. <i>Introduction</i>	75
B. <i>Buy Sell Agreements</i> ¹⁵⁰	76
C. <i>Pooling Agreements</i>	77
D. <i>Voting Trust</i>	78
VII. EMPLOYMENT CONTRACTS—SHAREHOLDER-EMPLOYEES	78
VIII. RESPONSIBILITIES AND LIABILITIES OF DIRECTORS AND OFFICERS	79
A. <i>General</i>	79
B. <i>Duty of Care</i>	79
C. <i>Duty of Loyalty</i>	79
IX. BOOKS AND RECORDS	80
X. TAX REQUIREMENTS	82
A. <i>Federal Tax Requirements</i>	82
B. <i>State Tax Requirements</i>	83

* Clinton Bristow, Jr. earned his B.S. degree in history and education from Northwestern University in 1971 and received a J.D. degree from Northwestern University School of Law in June 1974. He was admitted to the Illinois bar in November 1974. Upon graduation he began working on a Ph.D. in educational administration at Northwestern University.

INTRODUCTION

The purpose of this article is to give a broad overview of the legal considerations involved in the incorporation process for closely held corporations.¹ Major problems encountered in organizing will be highlighted and the reader will be referred to other references or articles in this journal for a more detailed discussion of such problems. Information on professional corporations² is also included because they have basically all the characteristics of a closely held corporation.

I. SELECTION OF THE BUSINESS ENTITY

The initial legal decision for the prospective businessman is the determination of the type of entity which he will use in the conduct of his business. Although this article deals principally with the closely held for-profit corporation, the decision of whether to incorporate can only be made by comparing the relative advantages of operating as a corporation, partnership or a sole proprietorship.

A. *Corporation v. Sole Proprietorship*³

The sole proprietorship form of business entity involves the one person

1. § 342 of the GENERAL CORPORATION LAW OF THE STATE OF DELAWARE provides a definition for the close corporation. This section reads:

(a) A close corporation is a corporation organized under this chapter whose certificate of incorporation contains the provisions required by section 102 of this title and, in addition, provides that:

(1) All of the corporation's issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of persons, not exceeding thirty; and

(2) All of the issued stock of all classes shall be subject to one or more of the restrictions on transfer permitted by section 202 of this title; and

(3) The corporation shall make no offering of any of its stock of any class which would constitute a "public offering" within the meaning of the United States Securities Act of 1933, as it may be amended from time to time.

(b) The certificate of incorporation of a close corporation may set forth the qualifications of stockholders, either by specifying classes of persons who shall be entitled to be holders of record of stock of any class, or by specifying classes of persons who shall not be entitled to be holders of stock of any class or both.

(c) For purposes of determining the number of holders of record of the stock of a close corporation, stock which is held in joint or common tenancy or by the entireties shall be treated as held by one stockholder.

For other materials on close corporations see: KESSLER, *NEW YORK CLOSE CORPORATIONS* (1968); O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* (1958); O'Neal, *Developments in the Regulation of the Close Corporation*, 50 *CORNELL L.Q.* 641 (1965); Israels, *The Close Corporation and the Law*, 33 *CORNELL L.Q.* 488 (1948).

2. The legal considerations applicable to organizing a closely held corporation are also applicable to the professional corporation. The professional corporation is a relatively new entity in most states and was recognized by the Internal Revenue Service in 1969. Anyone working with such entities should stay alert for new developments in the area. The following, however, are helpful initial references: EATON, *PROFESSIONAL CORPORATIONS* (1972); Strong, *Quick Reference Analysis of Professional Corporations Cases*, 32 *J. TAXATION* 96 (1970); Greenberg, *Special Problems of the Professional Corporation*, 20 *TUL. TAX. INST.* 82 (1971); Rosen, *Professional Corporations—Advantages and Disadvantages*, 6 *LAND & WATER L. REV.* 661 (1971); Weinberg, *Brief Look at the Advantages and Disadvantages of Professional Incorporation*, 6 *CREIGHTON L. REV.* 17 (1972-73); Baker, *Incorporation of the Firm*, 26 *TAX LAWYER* 77 (1972); see also 34 *J. TAXATION* (March 1971), *Special Feature on Professional Corporations*.

3. This section is taken in part from B. McWhirter, *Selection of the Business Entity, ORGANIZING AND ADVISING ILLINOIS BUSINESSES*, (Institute on Continuing Education of the Illinois Bar), § 1.2 (1968).

ownership and management of an unincorporated business. Generally, no detailed legal formalities are necessary to create an enterprise in this form. The sole proprietor is entitled to all of the profits and owns all of the assets of the business. He is personally liable for all of the obligations of the business. This liability extends to all of his personal assets as well as to his business assets. Personal liability, however, may be mitigated by securing liability insurance.

B. Corporation v. Partnership

1. Liability

A corporation is a separate legal entity⁴ whereas a partnership is an association of two or more persons who are co-owners of a business.⁵ This is an important factor in the selection of a business form because shareholders are not normally liable for the obligations of the corporation⁶ but each partner is individually liable for all obligations incurred by the partnership.⁷ If, however, the partnership is a limited partnership,⁸ a limited partner⁹ as such is not individually liable for the obligations of the partnership.¹⁰ A limited partner's liability is limited to his stated contribution in the enterprise,¹¹ provided the partnership agreement is publicly filed and if he thereafter observes various other rules,¹² the most important of which is that he takes no part in the management of business.¹³

Under certain circumstances courts will "pierce the corporate veil" and impose liability upon a shareholder.¹⁴ This could happen for instance where the controlling shareholder of a *de jure* corporation either completely neglects or ignores the conventional statutory requirements for operating a corporation.¹⁵

Although cases where the veil has been pierced are rare, the following precautions should be observed:¹⁶

4. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 4 L.Ed. 629 (1819).

5. UNIFORM PARTNERSHIP ACT, § 6(1) [hereinafter cited U.P.A.].

6. ABA-ALI Model Business Corporation Act, § 25 [Hereinafter, all statutory references will be to this act unless otherwise indicated. This Act will hereinafter be cited as M.B.C.A.].

7. U.P.A., § 15.

8. UNIFORM LIMITED PARTNERSHIP ACT, § 1 [hereinafter cited U.L.P.A.].

9. *Id.*

10. *Id.*

11. *Id.*, § 16.

12. See e.g., Comment, *Partnerships-Limited: Failure to Comply With Statutes as the Basis for Unlimited Liability*, 48 MICH. L. REV. 347 (1950).

13. U.L.P.A., § 7.

14. I. G. HORNSTEIN, CORPORATION LAW AND PRACTICE, § 20 (1959) [hereinafter cited as HORNSTEIN].

15. Majestic Factors Corp. v. Latino, 15 Misc. 2d 329, 184 N.Y.S.2d 658 (Sup. Ct. 1959) (individual liability was imposed here; the court held the absence of fraud to be immaterial where the corporation never functioned as such, i.e., never issued any stock, never had a bank account or other assets, never elected directors or officers, never held any stockholders' or directors' meetings, never filed any tax returns); see also Edward Finch Co. v. Robie, 12 F.2d 360 (8th Cir. 1926); Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959); Anderson v. Abbot, 321 U.S. 349, 64 S. Ct. 531 (1944); Chicago-Crawford Currency Exchange v. Thilens, Inc., 48 Ill. App. 2d 366, 199 N.E.2d 295 (1964).

16. For a discussion of the problems in this area, see W. FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS, §§ 41-46 (perm. ed. rev. repl. 1963).

1. The formalities of corporate procedure, including the holding of shareholders' and directors' meetings and the keeping of minute books should be complied with;
2. The corporation should be operated as a separate business and financial unit, with separate books and accounts, and without any intermingling of its funds, affairs, and transactions with those of the shareholders, officers, directors, or affiliated corporations;
3. No representation should be made which would lead outsiders to believe that the business is being conducted as a sole proprietorship or as a partnership; and,
4. The corporation should have adequate capital to meet its obligations and such contingencies as are reasonably to be expected in its business.

Defective incorporation, or failure to comply with the statutory requirements for establishing a *de jure* corporation, may also cause the shareholder to incur personal liability.¹⁷ Where unlimited liability is imposed, it is applied only to the managing or active participants in the transaction, not to the inactive participants.¹⁸ The consequences of defective incorporation vary depending on the jurisdiction and the judge except in states that have adopted the M.B.C.A.¹⁹ Sympathetic judges are influenced by elements such as substantial compliance, i.e., the degree or nature of the defect in the attempt to organize.²⁰ An analysis of the cases in this area can be found in a study by Professor Frey for the American Law Institute.²¹

Lending institutions will in many cases require the shareholders of closely held corporations to guarantee loans made to such corporations, thereby lessening the corporate advantage of limited liability. Also, the professional corporation may not be used to insulate professionals from liability for acts of professional misconduct such as malpractice.²²

17. For example, in *Robertson v. Levy*, 197 A.2d 443 (D.C. Cir. 1964), the plaintiff argued that the defendant was personally liable on a note executed in the corporate name by the defendant as the "corporation's" president, before the articles of incorporation were validly filed. The defendant knew of the defect when he executed the note. The plaintiff admitted, however, an intent to deal with a corporation. One payment by the corporation on the note was made and accepted after completion of incorporation. The District of Columbia statute under which *Robertson* was decided has two provisions from the M.B.C.A. One states that upon filing of the articles and issuance by the state of a certificate of incorporation, only the state can challenge *de jure* status. The other provision states: "All persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof." Relying on these two provisions, the court concluded:

We hold, therefore, that the impact of these sections when considered together, is to eliminate the concepts of estoppel and de facto corporateness under the Business Corporation Act of the District of Columbia. It is immaterial whether the third person believed he was dealing with a corporation or whether he intended to deal with a corporation. The certificate of incorporation provides the cut off point; before it is issued, the individuals, and not the corporation, are liable.

The defendant was, therefore, held personally liable.

18. HORNSTEIN, § 28; Magruder, *A Note on Partnership Liability of Stockholders in Defective Corporations*, 40 HARV. L. REV. 733 (1927); for a contrary view see Dodd, *Partnership Liability of Stockholders in Defective Corporations*, 40 HARV. L. REV. 521 (1927), where the author contends that a defective corporation which has not even colorably complied with the law so as to obtain a de facto existence is a partnership so far as the liability of stockholders to third persons is concerned; and, *Harrill v. Davis*, 168 F. 187, 195 (1909).

19. M.B.C.A., §§ 50 and 39; see note 17 *supra*.

20. HORNSTEIN § 28.

21. Frey, *Legal Analysis and the "De Facto" Doctrine*, 100 U. PA. L. REV. 1153 (1952).

22. *Blackmon v. Hale*, 83 Cal. Rptr. 194, 463 P.2d 418 (1970).

2. *Transferability of Interest.*

Stock in most instances may be freely transferred,²³ partnership interests, however, are not freely transferable. No person may become a member of a partnership without the consent of all the other partners.²⁴ Transfer, without consent, does not of itself dissolve the partnership.²⁵ In the absence of an agreement, it simply limits the rights of the assignee.²⁶ For example, the assignee is not entitled, as of right, to interfere in the management or administration of the affairs of the continuing partnership, or to require an accounting of partnership transactions, or to inspect the partnership's books.²⁷ He merely has the right to receive the profits to which the assignor would otherwise be entitled.

3. *Access to Capital.*

The corporate form may facilitate access to outside financing because new capital may be raised by selling stocks or bonds.²⁸ Also, a shareholder's stock may be pledged as security for a loan.²⁹ In the case of a partnership, however, outside capital is not normally raised by the sale of partnership interests, and partnership interests are not usually pledged for loans.

4. *Management*

Most corporation statutes provide for the management of corporate affairs by a board of directors which is chosen periodically by the shareholders.³⁰ In the partnership form, all general partners have the right to be involved in management.³¹ However, the partners may agree to a special allocation of voting control or management, and the partnership agreement can delegate the management of the business to one or more managing partners for the purpose of utilizing the advantages of centralized management.³²

Another problem in the management area is labor relations. But, this affects any type of business entity in the same manner as long as there is an employer-employee relationship.³³

5. *Tax Considerations*

Various tax advantages and disadvantages of doing business as a corporation as opposed to a partnership are discussed in detail in other articles

23. W. CARY, CORPORATIONS, at 24 (4th ed. 1969). Restrictions that may be placed on the transferability of shares will be discussed in the section on Shareholder Agreements.

24. U.P.A., § 18(g).

25. *Id.*, § 27.

26. *Id.*

27. *Id.*

28. M.B.C.A., § 15.

29. B. McWhirter, *Selection of the Business Entity* in ORGANIZING AND ADVISING ILLINOIS BUSINESSES, (Institute on Continuing Education of the Illinois Bar), § 1.8 (1968).

30. Recent revisions of the M.B.C.A., § 35, permits others to manage the affairs of the corporation if the charter so provides; § 36 also now permits the corporation to have a board of one.

31. U.P.A., §§ 18(e) and 24.

32. B. McWhirter, *Selection of the Business Entity*, *supra* note 29, § 1.14.

33. NATIONAL LABOR RELATIONS ACT, §§ 2(2) and (3).

in this Journal. This section, however, will point out some of the tax considerations of operating as a corporation.

Corporations are subject to federal income taxation,³⁴ and shareholders are also taxed on the dividends distributed by corporations.³⁵ This in effect is double taxation which can be avoided by some close corporations if they utilize the Subchapter S election under the Internal Revenue Code of 1954.³⁶ In general, taxation under Subchapter S substantially parallels the taxation of partnerships because partners, not partnerships, are subject to federal income taxation.³⁷

The double tax can also be avoided by having the shareholder-employee withdraw funds from the corporation as salary rather than dividends and by structuring the capital of the corporation so that a shareholder will also be a creditor of the corporation.³⁸ Both salary and interest payments are deductible by the corporation under sections 162(a)(1) and 163, of the Internal Revenue Code of 1954, respectively.

Qualified retirement plans can provide the corporation and shareholder-employee with many tax benefits. Such benefits are discussed in detail in another article in this Journal³⁹ and are only mentioned briefly here. Corporate contributions to pension plans, within certain limitations, are deductible by the corporation.⁴⁰ Stockholder-employees may be covered to the same extent as other employees, so long as there is no discrimination in favor of such stockholders.⁴¹ In a qualified plan, the employer's contribution creates no tax liability to the employee at that time. His liability is deferred. Further, the earnings and gains on the funds contributed to deferred compensation plans are non-taxable at the time they are earned.⁴² Each employee will be taxed on his appropriate share at the time he receives it.⁴³ If the employee receives his entire share in a lump sum, he will receive preferred tax treatment.⁴⁴ If he receives it in installments over a period of years, it will be taxable as ordinary income in the years received, at his then (presumably lower) income tax rate.⁴⁵

Members of a partnership, on the other hand, are not employees and cannot be beneficiaries under an exempt deferred compensation plan. However, under the *Self-Employed Individuals Retirement Act of 1962*, commonly known as the Keogh Plan, partners who own more than 10 percent

34. INT. REV. CODE OF 1954, § 11(a) [hereinafter cited as I.R.C.].

35. I.R.C. § 61(a)(7).

36. An electing small business corporation is in essence a domestic corporation which does not have more than 10 shareholders and whose shareholders elect to include in their personal income the current taxable income of the corporation.

37. I.R.C., § 1372.

38. I.R.C., § 701.

39. See Leonard Murray's article, *An Introduction to Deferred Compensation Arrangements*.

40. I.R.C., § 404(a).

41. I.R.C., § 401(a)(4).

42. A. Baum, *Qualified Retirement Plans* in ORGANIZING AND ADVISING ILLINOIS BUSINESSMEN, I.R.C. 501(a); see (Institute on Continuing Education of the Illinois Bar), §§ 17.13-17.23 (1968) [hereinafter "Baum"].

43. See, *Baum*.

44. I.R.C., §§ 402 and 403 generally.

45. I.R.C., §§ 72 and 402(a)(1).

of the capital or profit interest in the partnership may deduct the full amount of their contributions to a pension plan up to \$2500.⁴⁶

Other tax advantages available to shareholder-employees but not available to the partners are as follows:

- a. Corporate employees may receive tax-free the benefit of corporate payments for group term life insurance, up to \$50,000 of coverage.⁴⁷
- b. Corporate employees may receive tax-free the benefit of corporate payments for accident, health and sickness insurance plans, as well as medical and dental reimbursement plans.⁴⁸
- c. Payments to corporate employees while away from work due to sickness are exempt from income tax to the extent that they do not exceed \$75 per week (assuming this is less than 75% of the employee's regular salary). After 30 days, the exclusion is \$100 a week.⁴⁹
- d. Death benefits in respect of corporate employees, up to a maximum of \$5,000, are exempt from all tax. In some cases, this amount may be increased if it can be proved that such a payment constitutes a bona fide gift, rather than compensation.⁵⁰

II. PRE-INCORPORATION CONSIDERATIONS

A. Preliminary Agreement

A preliminary agreement, whether oral or written, usually precedes the formal organizing of any corporation with more than one shareholder.⁵¹ The preliminary agreement will set forth the arrangements for promoting the business⁵² and the means for dealing with other matters such as: (1) where and how the corporation is to be organized; (2) how much each shareholder will contribute; (3) the source of future finances; (4) how shares of stock and other securities are to be allocated; (5) allocation of voting power; and (6) determination of officers and salaries.⁵³

The preliminary agreement is put together prior to the drafting of the shareholders' agreement, which is a written contractual agreement among the shareholders with respect to control of the corporate affairs. Many provisions of the preliminary agreement may be incorporated into the shareholders' agreement.⁵⁴

B. Pre-incorporation Subscription Agreements For The Issuance of Shares⁵⁵

A subscription agreement is an agreement between a corporation or a corporation to be formed (made on its behalf by incorporators, agents or

46. *But see* H.R. Res. 2 (1974) which will increase the limitation on deductions to 15% of income or a maximum of \$7500 per year.

47. I.R.C. § 79(a).

48. I.R.C., § 105(b).

49. I.R.C., § 105(d).

50. I.R.C., § 101(b).

51. HORNSTEIN § 95.

52. R. Clark, *Formation of Corporations* in ORGANIZING AND ADVISING ILLINOIS BUSINESSES, (Institute on Continuing Education of the Illinois Bar), § 7.5 (1968).

53. HORNSTEIN, § 91.

54. *Id.*

55. The law relating to subscription agreements is not a major concern currently because most companies are generally financed through the outright sale of stock. These sales are reg-

trustees) and a subscriber.⁵⁶ The corporation agrees to issue shares and the subscriber agrees to purchase them. The major problem with pre-incorporation subscription agreements is their enforceability. The problem centers around the question of when the agreement becomes binding on the subscriber. In the absence of statute, the majority view is that the subscription agreement may be revoked any time prior to the filing of the articles of incorporation, or prior to some kind of effective action by an existent corporation.⁵⁷

Since a pre-incorporation subscription agreement is not considered a sale of goods within the Statute of Frauds, it need not be in writing unless it is for more than one year. However, some statutes now specifically provide that no subscription is valid unless in writing.⁵⁸

C. Corporate Name

The articles of incorporation, i.e., the formal corporate charter, must provide a name for the corporation that is not presently the name of an existing corporation.⁵⁹ Therefore, as a precautionary measure, a check of business names within the state of incorporation should be made before filing the articles. Availability of names can be ascertained from the appropriate state official, usually the Secretary of State. If a name is available, statutes in several states permit it to be reserved for a period of time ranging from 10 days to a year for a small fee.⁶⁰ Where there is no formal reservation system, the state official, as a matter of administrative courtesy, may reserve the name for a period ranging up to 30 days without charge.

Another caveat in the selection of the corporate name is the determination of required and prohibited words in the corporate name. For example, most states require the corporate name to include the term "corporation", "incorporated" or "limited" or some other word or abbreviation to indicate limited liability.⁶¹

ulated by strict federal and state securities laws which are discussed in William Jackson's article, *Federal and State Securities Laws and The Closely Held Corporation*. Non-compliance with the federal and state securities laws can result in private suits for damages, rescission of stock sold or criminal liability. Mention of subscription agreements is made herein because some jurisdictions may still require minimal subscriptions, and promoters (people who undertake to form a corporation and to procure for it capital) may still enter into a subscription agreement at the inception of a business. For a further discussion of subscription agreements, see §§ 17 and 25 of the M.B.C.A. and Cataldo, *Conditions in Subscriptions for Shares*, 43 VA. L. REV. 353 (1957); Morris, *Legal Effect of Pre-Incorporation Stock Subscriptions*, 34 W. VA. L.Q. 219 (1928); Lukens, *Withdrawal and Acceptance of Pre-Incorporation Subscriptions to Stock*, 76 U. PA. L. REV. 423 (1928); Frey, *Modern Development in the Law of Pre-Incorporation Subscriptions*, 79 U. PA. L. REV. 1005 (1931).

56. CARY, CORPORATIONS, at 1033; BALLANTINE, CORPORATIONS, at 450, 451 (1946).

57. Cataldo, *Conditions in Subscriptions for Shares*, 43 VA. L. REV. 353 (1957); Collins v. Morgan Grain Co., 16 F.2d 253 (9th Cir. 1926).

58. N.Y. Bus. Corp. Law., Section 503(b) (McKINNEY); MINN. STAT. ANN. Section 301.17, LA. REV. STAT. ANN. 12:71; KY. REV. STAT. 271.075.

59. M.B.C.A., Section 8.

60. E.g., THE ILL. BUSINESS CORPORATION ACT, Section 10(e) provides for a 60 day reservation.

61. N.Y. Gen. Corp. Law, Sections 9, 9(a), 9(c), 215 McKINNEY; ILL. BUSINESS CORPORATION ACT, Section 9(a) [hereinafter cited ILL. BUS. CORP. ACT].

D. *State of Incorporation*

Normally, a closely held corporation will be incorporated in the state in which it will operate.⁶² A corporation will have to pay an "entrance" tax and an annual "privilege" tax to the state where it actually engages in business, even if organized under an out of state charter.⁶³

Other considerations are the nature of the state's corporation laws and how favorable to the corporation the laws are interpreted by the state's courts. Delaware is a state with liberal corporation laws, and the courts and the legislature have established a reputation for sympathetic handling of corporation matters. The advantages of greater flexibility which may be available under out of state incorporation will, however, rarely offset the ever present danger of jurisdiction in the courts of the incorporating state to appoint a receiver for the corporation⁶⁴ or to pass upon questions of ownership of capital stock, since the situs of ownership is there.⁶⁵ Also, the selection of a state of incorporation may affect personal estate planning. For example, a number of states impose an estate or an inheritance tax on shares of domestic corporations owned by non-resident decedents,⁶⁶ but most states that do so grant exemptions from this tax on a reciprocity basis.

Once the organizational plan has been formulated, the federal tax consequences of incorporation must then be considered. A detailed discussion of such tax consequences can be found in another article in this Journal;⁶⁷ however, a brief discussion follows.

No gain or loss is recognized by a corporation on the issuance of its stock or securities for cash or other property.⁶⁸ On the other hand, transfer of property to a corporation in exchange for stock is a taxable transaction to the shareholder unless specifically exempted by statute. Section 351 of the Internal Revenue Code of 1954 provides such an exemption. It, in general, permits the tax-free transfer of a business, or property to be used in a business, to a corporation in exchange for stock if the transferor or transferors are in *control* of the transferee corporation immediately after the transfer.⁶⁹ Control is defined as at least 80 percent of the issued and outstanding shares of voting stock and 80 percent of the total number of shares of all other classes of stock outstanding.⁷⁰ Securities include long term bonds and notes, but not short term obligations.⁷¹ If in addition to stock or securities, the controlling shareholders also receive cash or other property, generally referred to as boot, gain will be recognized to the extent of such money and the fair market value of the other property.⁷²

62. G. Seward, *Basic Corporate Practice*, at 39 (ALI-ABA) (1966), [hereinafter cited as Seward].

63. *See, e.g.*, ILL. BUS. CORP. ACT., Sections 135-140.

64. *Gen. Corp. Law of Delaware*, Section 292.

65. *Gen. Corp. Law of Delaware*, Section 169.

66. *See, CCH INHERITANCE ESTATE & GIFT TAX REPORTER*, Paragraph 12,080.

67. *See the article by Robert Bramlette in this volume.*

68. I.R.C., Section 1032(a).

69. I.R.C., Section 351(a).

70. I.R.C., Section 368(c).

71. *Camp Welters Enterprises v. Commissioner*, 230 F.2d 555 (5th Cir. 1956).

72. I.R.C., Section 351(b).

The assumption of liabilities by the acquiring corporation will not prevent non-recognition of gain on the exchange unless (1) there was no bona fide business purpose, (2) the transaction was designed to avoid federal income tax,⁷³ or (3) the amount of the liabilities transferred to the corporation exceeds the adjusted basis of the property⁷⁴ transferred.

There may be special problems on the issuance of stock for services in a section 351 transaction. Stock issued for services will constitute ordinary income to the shareholder, and will be deductible by the corporation.⁷⁵ A recipient of stock issued solely for services rendered or to be rendered will not be considered a transferor for the purpose of determining whether 80 percent control has been retained by the transferors of property.⁷⁶

It should be noted that the non-taxable exchange at the time of formation of the corporation will have tax ramifications later. For example, if appreciated property has been transferred to a corporation in a tax-free exchange, both the shareholder⁷⁷ and the corporation⁷⁸ take the low basis which the property had in the hands of the transferor-shareholder at the time of the exchange. If the corporation sells the property at a gain and the shareholder sells the stock, both are taxable on the appreciated value.⁷⁹

III. CAPITAL STRUCTURE

A. *Stated Capital*

Stated capital is the equity investment by the shareholders intended to be permanently devoted to the business.⁸⁰ Under most corporation statutes and the M.B.C.A. it is not necessary that all the consideration received by the corporation on the sale of its shares be included as stated capital.⁸¹ The par value of shares, however, must be included in stated capital; consideration in excess of par will be capital surplus unless the directors designate additional amounts as stated capital.⁸² Therefore, if an enterprise issues \$1.00 par value shares for \$100.00, there will be stated capital of \$1.00 and capital surplus of \$99.00. In the case of shares without par value, the M.B.C.A. authorizes the board of directors, within 60 days, to allocate to stated capital any portion of the consideration received for the issuance of such shares.⁸³ Capital surplus, in some cases, may be available for dividend distributions, whereas stated capital is not.

B. *Allocation of Interests*

In planning the capitalization a determination must be made as to the

73. I.R.C., Section 357(a) and (b).

74. I.R.C., Section 357(c).

75. I.R.C., Section 61(a)(1) and Section 351(a).

76. I.R.C., Section 351(a).

77. I.R.C., Section 358(1).

78. I.R.C., Section 362(a).

79. I.R.C., Sections 1001 and 1002.

80. M.B.C.A., Section 2(j).

81. *Id.*, Section 21.

82. *Id.*, Section 21.

83. *Id.* Stated capital can be reduced in certain instances.

type of stock and securities to be issued.⁸⁴ The corporation may issue, for example, secured and unsecured bonds, preferred stock and common stock. The holders of bonds are creditors of the corporation. Preferred shareholders usually have preferences on dividends and assets on liquidation. The holders of common stock own the basic equity of the corporation which is the amount of the net assets remaining after the claims of all creditors and preferred shareholders have been satisfied.⁸⁵ There are no limitations on the types of stocks or securities that an individual can hold. For instance, one person may own 100% of a corporation's common, preferred and bonds.

A corporation may have several different classes of preferred or common stock. Usually, this is done in order to establish the voting rights of the shareholders for control purposes. The allocation of voting power is an important aspect in planning a capitalization.⁸⁶

It must be emphasized that the capital structure of the closely held corporation will be determined by the bargaining power between the shareholders. For example, the shareholder contributing the most capital or property may request preferred stock, which will entitle him to preferred treatment at the time of dividend distribution and liquidation. Senior securities such as preferred stock may play a significant role in adjusting the interests of the entrepreneurs when they are making unequal contributions of capital.

A major problem encountered in this area is the bar against the issuance of stock for future services.⁸⁷ This rule, however, can be easily circumvented. A person who is to receive stock in exchange for future services or other doubtful consideration may bring the issuance within the statute dealing with eligible consideration⁸⁸ by contributing a small amount of qualified property.⁸⁹ For example:

If service man (S) and capital man (C) were to form a new corporation with authorized capital of 1,000 shares of no-par stock, to be divided evenly between them, a consideration of as little as \$500 might be set for the shares to be issued to S, even though the consideration for the 500 shares to be issued to C was \$50,000. So long as the assets and the paid-in capital on the corporation's financial statements were each carried at no more than \$50,500 as a result of the transaction, there would seem to be no basis for attacking [it] either at the outset or upon the later [challenge] by creditors.⁹⁰

C. *Thin Incorporation and Inadequate Capitalization*

Thin incorporation occurs when there is a high ratio of corporate debt to equity and is a problem that has to be guarded against in the capitalization planning process. The Internal Revenue Service may, for instance, claim

84. L. Coles, *Financing the Illinois Business*, in ORGANIZING AND ADVISING ILLINOIS BUSINESSES, (Institute on Continuing Education of the Illinois Bar), Sections 2.30-2.43 (1968).

85. *Id.*

86. Herwitz, *Allocation of Stock Between Services and Capital In the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962). The proper allocation of ownership interests is an extremely important area. The Herwitz article is the leading work in this area and should, by all means, be consulted before finalizing the allocations of interest.

87. M.B.C.A., § 19.

88. *Id.*, §§ 18 and 19.

89. Herwitz, *supra* at note 121.

90. *Id.*

that funds loaned by a sole or majority shareholder to an undercapitalized corporation are in effect equity and should be treated as such for tax purposes. In such case, interest paid on the alleged debt would not be deductible and other preferred treatment would be denied.⁹¹ The thin incorporation doctrine has been applied principally to advances by a sole shareholder or to advances by all shareholders on a proportionate basis. The doctrine, in general, will not apply if the loan is one which a third party non-shareholder would be willing to make on the same terms. Under section 385 of the Internal Revenue Code of 1954, the Treasury is now authorized to prescribe regulations with respect to whether an ownership interest is debt or equity.

The legal doctrine of inadequate capitalization has been applied in corporate reorganizations to subordinate the debt claims of a common shareholder parent corporation to the equity claims of public preferred shareholders under the "Deep Rock doctrine."⁹² Also, it has been applied to deny an individual common shareholder the status of a creditor in bankruptcy with respect to funds purportedly loaned to the corporation.⁹³

D. Section 1244 Small Business Stock

The small investor should insist that his common stock be set up to qualify as "section 1244" small business stock⁹⁴ under the INTERNAL REVENUE CODE of 1954. If the business qualifies, shareholders can have an ordinary loss for tax purposes rather than a capital loss if the business is a failure⁹⁵ and the stock becomes worthless. Any loss realized on worthless⁹⁶ common stock held by an individual shareholder, who acquired his stock from the corporation, will be available as a deduction against ordinary income, subject to an annual limitation of \$25,000 or \$50,000 in the case of a joint return.⁹⁷

To qualify as section 1244 small business stock, the capitalization must consist of one and only one class of common stock.⁹⁸ Such stock must be issued pursuant to a written plan,⁹⁹ which can be a resolution of the board of directors. The corporation must not be offering any other stock at the time, whether by way of options, outstanding convertible issues, or otherwise. The stock offering plan must be limited to two years.¹⁰⁰

91. See *Rev. Rul. 54, 1968-1 CUM. BULL. 6*, at 7 for a listing of the factors which the Internal Revenue Service considered pertinent in ascertaining whether debt is valid; and, Hickman, *The Thin Corporation: Another Look at an Old Disease*, 44 *TAXES* 883 (1966).

92. The doctrine was originally applied in *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 59 S. Ct. 543, 83 L.Ed. 669 (1939) (in reorganization of subsidiary corporation, holding company's claim as creditor subordinated to creditors and preferred shareholders of subsidiary because of several acts of improper management of subsidiary for the benefit of the parent and because of the inadequate capitalization of the subsidiary). For recent cases see *Bankers Life and Casualty Co. v. Kirtley*, 338 F.2d 1005 (8th Cir. 1964), and cases cited in HORNSTEIN, § 756 (Supp. 1968).

93. *Arnold v. Phillips*, 117 F.2d 497 (5th Cir. 1941).

94. M. Smith and Tannenbaum, *Second Circuit Defines Components of a Well Written Plan Under Section 1244*, 29 *J. TAXATION* 66 (1968).

95. I.R.C., § 1244(a).

96. I.R.C., § 165(g).

97. I.R.C., § 1244(b).

98. I.R.C., § 1244(c)(1)(A).

99. *Treas. Reg.*, 1.1244(c)-(1)(c); *Bruce v. U.S.*, 270 F. Supp. 686 (S.D. Tex. 1967).

100. I.R.C., § 1244(c)(1)(A).

There are two major limitations that must be considered when attempting to qualify under section 1244. First, the amount offered under the plan plus any amounts received by the corporation as a contribution to capital or as paid in surplus may not exceed \$500,000. Second, the entire existing capital of the corporation plus the amount offered under the plan may not exceed \$1,000,000. In addition to the above limitations, the corporation must derive more than 50 percent of its gross receipts from sources other than royalties, rents, dividends, interest, etc. The investor must also have purchased his stock directly from the corporation.¹⁰¹

E. *Loan Agreements*

Since bank loans are one of the common means of obtaining financing it is important to point out some of the considerations in the drafting of loan agreements. A loan agreement is an on-going contract which may have a life span of a number of years. Because of this factor, the borrower's attorney must take due care to see that the agreement, its covenants, restrictions, default provisions, etc., are reasonably related to the borrower's needs.¹⁰² In order to do this, the borrower's attorney should refuse to accept standard loan agreements and instead come up with viable alternatives which provide the borrower with the needed flexibility, without impairing the security of the lender.¹⁰³ Some of the following are pertinent considerations:

1. In conducting the negotiations, the borrower must be influenced by many circumstances, including the probable ease with which modifications can be obtained in the future, should the need arise, or if unobtainable, whether the debt can be paid off;
2. The proper formulation of the operational restrictions and covenants of the loan agreement must involve a determination of those types of corporate transactions that will be permitted so that the borrower can insure that the loan agreement is drafted sufficiently broad to accommodate alternative methods of accomplishing the same business objective; and
3. In connection with default provisions, which so many borrowers seem to overlook, it is desirable to include a provision requiring the giving of notice of default and allowing a grace period within which to correct the default as a pre-condition to the creation of an enforceable default giving rise to acceleration.¹⁰⁴

IV. THE ARTICLES OF INCORPORATION

The articles of incorporation is the formal corporate charter which is filed with the Secretary of State in the state of incorporation.¹⁰⁵ It must contain the minimum required provisions set out in the corporate law of the

101. I.R.C. Section 1244(c)(2). Stock purchased from a shareholder will not qualify for 1244 treatment. Boughner, *Tax Advantages in Incorporating the Small Business*, 44 Ill. B.J. 300 (1956).

102. Mandel, *The Preparation of Commercial Agreements*, (1970).

103. For a detailed discussion on how to draft loan agreements to favor the borrower, see Simpson, *The Drafting of Loan Agreements: A Borrower's Viewpoint*, 28 Bus. Lawyer 1161 (July, 1973).

104. *Id.*

105. M.B.C.A., Section 55.

state of incorporation. The minimum provisions can be obtained from the Secretary of State's office.¹⁰⁶ General provisions which may be found in the articles are discussed in the following paragraphs.

Name - The name of the corporation which has been verified and reserved as mentioned above should be the first thing stated in the articles.

Duration - The period of duration should be spelled out even though the period is usually perpetual.

Purpose - The purposes permitted under the M.B.C.A. are any or all lawful business purposes except the purpose of banking or insurance.¹⁰⁷

Powers - Businesses incorporated under the M.B.C.A. may have broad and comprehensive powers.¹⁰⁸ Failure to insert provisions relating to powers in the charter will be an election to have comprehensive powers.¹⁰⁹

Issuance of Shares - The articles should set forth the total number of shares that the corporation has authority to issue, listing the number of these shares, both with and without par value. The articles must also spell out permissible dividend sources. The primary source for dividends under the M.B.C.A. is unreserved and unrestricted earned surplus.¹¹⁰ However, under the M.B.C.A. capital surplus is also a permissible source for dividends, if provided for in the articles.¹¹¹ Capital surplus generally may not be used for dividends unless all cumulative preferential dividends have been paid and its use will not impair the asset preference of preferred shares.¹¹² The M.B.C.A. also contains a provision restricting the declaration of a dividend in those cases where the corporation is insolvent or when the payment thereof would render the corporation insolvent. This provision may be avoided by a revaluation of assets in order to create a surplus.¹¹³ However, most authorities strongly admonish against such a practice and advise that a charter restriction should be placed upon the use of a revaluation surplus to create a source for ordinary dividends.¹¹⁴

Voting - Under the M.B.C.A. each outstanding share, regardless of class,¹¹⁵ is entitled to one vote on each matter submitted to a vote at a meet-

106. Pantzer and Deer, *The Drafting of Corporate Charters*, (ALI-ABA), at 32, (2d ed. 1968). M.B.C.A., Section 54.

107. M.B.C.A., Section 3.

108. M.B.C.A., Section 4.

109. Pantzer and Deer, *supra*, at 142.

110. M.B.C.A., Sections 45(a), 2(k), 2(1); Earned surplus for dividend purposes means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.

111. M.B.C.A., § 46.

112. M.B.C.A., § 46(c) and (d).

113. M.B.C.A., §§ 45 and 2(n). In many states revaluation surplus is a prohibited source for declaring dividends.

114. DEER, *THE LAWYER'S BASIC CORPORATE PRACTICE MANUAL*, (ALI-ABA), at 41, (1968).

115. "The classification of stock affords opportunities to control shareholder voting. If two persons agreed to invest \$5,000 each in a corporation, and if A obtained 50 preferred shares or 50 class A common shares at \$100 par value per share for his \$5,000, and B obtained 5000

ing of shareholders, except as may be otherwise provided in the articles of incorporation.¹¹⁶ The M.B.C.A. also gives a class of shares a right to vote as a class on any of the amendments specified in the corporate law of the state even though the class has no voting rights under the articles of incorporation.¹¹⁷ These rights may be expanded but not abridged.¹¹⁸

The M.B.C.A. affords every class a vote on mergers, consolidations, and sale or disposition of assets not made in the regular course of business.¹¹⁹ Preferred investors in small businesses may want their class voting rights improved and spelled out in the articles of incorporation.

Minority shareholders may insist that the articles of incorporation give them the opportunity to gain representation on the board of directors, in proportion to their holdings through cumulative voting.¹²⁰ Under cumulative voting each shareholder is entitled to votes equal to the number of his shares multiplied by the number of directors to be elected. He may cast his votes for a single director, or distribute them among the candidates.¹²¹ Cumulative voting can prove to be very beneficial to minority shareholders. For instance, in *Pierce v. Commonwealth*,¹²² the majority did not cumulate its vote, but distributed them equally over the six directors to be elected. The opposition, however, cumulated its votes on four candidates who were elected. The election, which resulted in the majority losing control, was upheld by the court which ruled that this was simply the exercise of a constitutional right.¹²³

Pre-emptive Rights - Absent contrary provisions in a state statute or the articles of incorporation, a shareholder, in general, will have the right to subscribe to additional stock issued in proportion to his holding of outstanding shares.¹²⁴ Such rights are termed pre-emptive rights. In the closely held corporation, pre-emptive rights are usually granted to the holders of shares that have general voting rights.¹²⁵ Unless provided otherwise

common shares or class B common shares at \$1 par value per share for his \$5,000, A would have 50 votes and B would have 5,000 votes." See Sprecher, *Organizing Closely Held Corporations*, in ORGANIZING AND ADVISING ILLINOIS BUSINESSES, (Institute on Continuing Education of the Illinois Bar), § 8.12, (1968).

116. M.B.C.A., § 33.

117. M.B.C.A., § 60.

118. *Id.*

119. M.B.C.A., § 73.

120. Cumulative voting is provided for in the Constitution of some states, e.g., NEBRASKA CONSTITUTION, art. 12, § 5, and some courts have held that these rights may not be abridged, e.g., see *Sensabaugh v. Polson Plywood Co.*, 135 Mont. 562, 342 P.2d 1064 (1959) and *Wolfson v. Avery*, 6 Ill. 2d 78, 126 N.E.2d 701 (1955). For a contrary view, see *Janney v. Philadelphia Transportation Co.*, 387 Pa. 282, 128 A.2d 76 (1956).

121. ILL. BUS. CORP. ACT, § 28, DELA. CORP. LAW, §§ 214 and 141(d); N.Y. BUS. CORP. LAW, § 618 (McKINNEY). For more information on cumulative voting see Williams, *Cumulative Voting*, 33 HARV. BUS. REV. 108 (1955); Steadman and Gibson, *Should Cumulative Voting for Directors Be Mandatory?*, 11 BUS. LAW 9 (1955); Campbell, *The Origin and Growth of Cumulative Voting for Directors*, 10 BUS. LAW 3 (1955).

122. 104 Pa. 150 (1883).

123. Similar instances in which the majority has lost control and the courts have refused to invalidate the election are found in *Schwartz v. State ex rel. Schwartz*, 61 Ohio St. 497, 56 N.E. 201 (1900); and, *Chicago Macaroni Mfg. Co. v. Boggiano*, 202 Ill. 312, 67 N.E. 17 (1903).

124. N.Y. BUS. CORP. LAW, §§ 622(b) and (c), (McKINNEY).

125. PANTZER AND DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BY-LAWS*, (ALIBABA), at 61 and 62, (1968).

in the articles of incorporation, the M.B.C.A. denies pre-emptive rights.¹²⁶

Transactions with Interested Directors - The articles of incorporation should contain provisions governing transactions where interested directors are involved. The trend is to permit such transactions, if fair.¹²⁷ However, an otherwise lawful transaction in which a director has a financial interest may be voidable if the director's interest is not fully disclosed to the board. The interested director is not counted for quorum or voting purposes when the board considers such transactions.¹²⁸

Indemnification - In the absence of statutory provisions, any right to indemnification of a director is limited to those rights conferred in the articles of incorporation. For the most part, a director is required to defend his actions successfully on the merits¹²⁹ and may also be required to demonstrate that his defense has benefitted the corporation.¹³⁰ However, corporate authority to indemnify directors has been sanctioned by some courts even where there is no express statute or charter provision.¹³¹ Among other things directors cannot be indemnified for violations of the Securities Act of 1933.¹³²

Removal of Directors - Absent an express statutory or charter provision for the shareholders' removal of directors, removal will be allowed by some courts only for cause and then only after the director has been put on notice and allowed a hearing.¹³³ Removal without cause is provided for in the M.B.C.A. on an optional basis.¹³⁴ Director removal of other directors is generally not permitted.¹³⁵ Thus, prior to drafting the provision for the removal of directors, it is important to examine the substantive law of the state.

V. THE BY-LAWS

The by-laws provide the rules for the administration and regulation of the affairs of the corporation.¹³⁶ The by-laws usually contain a wide variety of provisions subject only to the requirement that they be consistent with the articles and other provisions made mandatory by state law.¹³⁷ If the

126. M.B.C.A., § 26.

127. *Shlensky v. South Parkway Building Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960). Here, the court held that transactions between corporations with common directors may be vacated only if unfair and . . . the directors who would sustain the challenged transaction have the burden of overcoming the presumption against the validity of the transaction by showing its fairness. See also *Evansville Public Hall Co. v. Bank of Commerce*, 144 Ind. 34, 42 N.E. 1097 (1896); *South Side Trust Co. of Pittsburgh v. Washington Tin Plate Co.*, 252 Pa. 237, 97 A. 450 (1916); *Caldwell v. Dean*, 10 F.2d 299 (5th Cir. 1925).

128. *Miller v. Ortman*, 235 Ind. 641, 136 N.E.2d 17 (1956); *Wainwright v. P.H. & F.M. Roots Co.*, 176 Ind. 682, 97 N.E.8 (1912).

129. *In re E.C. Warner Co.*, 232 Minn. 207, 45 N.W.2d 388 (1950); and, *Solimine v. Hollander*, 129 N.J. Eq. 264, 19 A.2d 344 (1941).

130. *New York Dock Co. v. McCollom*, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

131. *Esposito v. Riverside Sand & Gravel Co.*, 287 Mass. 185, 191 N.E. 363 (1934).

132. *Loss, SECURITIES REGULATION*, §§ 1832-33 (2d ed. 1961).

133. *Essential Enterprises Corp. v. Automatic Steel Products*, 39 Del. Ch. 105, 159 A.2d 288 (1960); *Toledo Traction Light & Power Co. v. Smith*, 205 F. 643, (N.D. Ohio 1963).

134. M.B.C.A., § 39.

135. *Stott v. Stott Realty Co.*, 246 Mich. 267, 224 N.W. 623 (1929).

136. M.B.C.A., § 27.

137. M.B.C.A., § 27.

following are not contained in the articles of incorporation, they must be contained in the by-laws: time of the annual meeting of shareholders, the number of directors except for the initial board, provisions governing notice of directors' meetings, and the time and manner of election or appointment of officers.¹³⁸ These provisions satisfy the minimum statutory requirements of the M.B.C.A.

In addition to the above, the by-laws should also reiterate the statutory provisions on stock certificates.¹³⁹ For instance, the M.B.C.A. requires that the face of each certificate state: (1) that the corporation is organized under the laws of the particular state; (2) the name of the person to whom issued; (3) the number and class of shares and the designation of the series, if any, that the certificate represents; and, (4) the par value of each share represented by the certificate or a statement that the shares are without par value.¹⁴⁰ If the corporation is authorized to issue more than one class of stock, the M.B.C.A. requires that the certificate state that the corporation will furnish to any shareholder upon request and without charge a full statement of the "designations, preferences, limitations, and relative rights of the shares of each class."¹⁴¹

It is also necessary to clear up several other operational matters in the by-laws. For instance, provisions for replacement of lost, stolen, or destroyed certificates should be made.¹⁴² The by-laws should also give explicit guidance with respect to dividend distributions, fiscal year, place of annual shareholders' meetings, notice period for the annual meeting, notice period for special meetings, waiver of notice, written consent in lieu of shareholders' meeting, voting lists for shareholders' meetings and quorum at shareholders' meetings.¹⁴³

Another significant part of the by-laws will deal with directors. The by-laws should re-state the statutory provisions in the state of incorporation relating to directors' qualifications, elections and vacancies. The by-laws should also contain provisions governing the holding of directors meetings, notice of such meetings, quorum, attendance at the meetings, waiver of notice, written consent in lieu of meetings and indemnification provisions to protect directors and officers against liabilities arising from board actions taken in good faith but questioned by shareholders.¹⁴⁴

VI. SHAREHOLDERS AGREEMENTS

A. Introduction

Shareholders' agreements can be used to allocate powers between shareholders and directors and to control the corporation, among other things. Such agreements are becoming an approved means of regulating

138. M.B.C.A., §§ 28, 29, 32, 36, 37 and 40.

139. M.B.C.A., § 23.

140. *Id.*

141. M.B.C.A., § 21; PANTZER AND DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BY-LAWS*, (ALI-ABA), 77-78 (2d ed. 1968).

142. UNIFORM COMMERCIAL CODE, § 8-405.

143. PANTZER AND DEER, *supra*, footnote 141.

144. *Id.*

the affairs of closely held corporations,¹⁴⁵ and are expressly recognized by the M.B.C.A.¹⁴⁶

One subject covered in a shareholders' agreement is the distribution of powers between directors and shareholders.¹⁴⁷ Absent such agreement, the shareholders elect directors, but only the latter thereafter make policy decisions and in most states appoint the officers.¹⁴⁸ A shareholders agreement cannot completely strip directors of their commonly recognized powers such as managing the business affairs of the corporation, etc. unless authorized by a state statute.¹⁴⁹

B. Buy Sell Agreements¹⁵⁰

Buy-Sell Agreements are shareholders agreements which provide for restrictions on the transferability of shares by giving the shareholders, the corporation, or both, the option to purchase the shares of a shareholder upon the happening of a specified event such as death, incapacity, termination of employment, or a desire to sell. They are desirable in a close corporation situation for a variety of reasons. The organizers may want to continue to be in a position to choose their future business associates, or to prevent competitors from being able to buy into the corporation, or to maintain the corporation's private offering¹⁵¹ or intrastate exemption¹⁵² under sections 4(2) and 3(a)(11) of the 1933 Securities Act. The implication of such restriction, on the 1933 Securities Act is discussed in another article in this Journal.¹⁵³

Another reason for restrictions may be to insure continued Subchapter

145. *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1965).

146. M.B.C.A., § 34.

147. HORNSTEIN, § 171.

148. *Id.*

149. *Id.*, *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936).

150. Buy-sell agreements and other buy-out arrangements have usually been held valid. Not only have the courts consistently held that such agreements are not testamentary, *e.g.*, *Chase National Bank v. Manufacturers Trust Co.*, 265 App. Div. 406, 39 N.Y.S.2d 370 (1943), but they have also granted specific performance of such agreements, *e.g.*, *see Bohnsack v. Detroit Trust Co.*, 292 Mich. 167, 290 N.W. 367 (1940), particularly when the stock involved consisted of shares in a closely held corporation. See also the article by Wrede Smith.

151. § 4(2) of the 1933 Securities Act exempts from registration under § 5 of the Act transactions by an issuer not involving any public offering. This exemption usually allows issuers to offer and sell securities to a limited number of sophisticated investors who do not require the protection afforded by a registration statement and prospectus and who have no intention of distributing the securities so purchased. *E.g.*, *see S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981 (1953) and the article by William Jackson.

152. § 3(a)(11) exempts from the 1933 Securities Act any security which is a part of an issue offered and sold only to persons resident within a single State . . . where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State.

153. For a detailed discussion of Subchapter S status for close corporations and the requirements thereof see Professor Thompson's, and the following references: BITTKER AND EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, at 6.1 (1959); Caplin, *Subchapter S v. Partnership: A Proposed Legislation Program*, 46 VA. L. REV. 61 (1960); Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1 (1965); Meyer, *Subchapter S Corporations*, 36 TAXES 919 (1958); Foberts and Alpert, *Subchapter S: Semantic and Procedural Traps in its Use; Analysis of Dangers*, 10 J. TAXATION 2 (1959).

S status. Subchapter S of the *Internal Revenue Code* of 1954 permits close corporations meeting certain requirements to elect a tax status virtually paralleling that of a partnership.¹⁵⁴ Among the minimum requirements for eligibility is that the corporation must not have more than ten shareholders and the shareholders must be individuals or estates. If a shareholder transfers shares to a corporation or trust or if he divides his shares and transfers them to a number of persons thereby generating more than ten shareholders, the corporation's status as a Subchapter S corporation will be terminated.¹⁵⁵ Furthermore, even if the shares are transferred to an eligible shareholder, his consent to the continuance of the election of Subchapter S status must be obtained.¹⁵⁶ Therefore, whenever shareholders plan to cause the corporation to elect Subchapter S status, it is wise to place restrictions on the transferability of stock in order to prevent the loss of Subchapter S status.

Restrictions on the transferability of shares must be reasonable.¹⁵⁷ The test for reasonableness seems to be whether the restraint is sufficiently needed by the particular corporation to overcome the general policy against restraints on alienation.¹⁵⁸

The funding of buy-sell agreements raises substantial tax problems which are discussed in another article in this Journal.^{158a} However, the most common method of funding purchases at death is by having the corporation acquire insurance on the lives of its shareholders and use the insurance proceeds to redeem a deceased shareholder's stock.

C. Pooling Agreements

So extensive is the power of the board of directors that shareholders in a close corporation should make every effort to assure themselves that the identity of the board will be acceptable to them.¹⁵⁹ One type of shareholder agreement used to achieve this purpose is a pooling agreement. Pooling agreements are agreements whereby shareholders combine their voting rights to elect specified directors to manage the close corporation.¹⁶⁰ A pooling agreement may take various forms:

1. Each shareholder may agree that as long as he remains a shareholder he will vote his shares for the election of each of the other shareholders as directors;
2. Each shareholder may agree that as long as he remains a shareholder he will vote his shares upon any matter requiring action by the shareholders only as the shareholders may agree; and
3. Each shareholder may agree that as long as he remains a shareholder he will vote his shares for the election of directors only as the shareholders may agree.

154. REPORT OF THE SENATE FINANCE COMMITTEE, S. REP. NO. 1983, 85th Cong., 2d Sess. 68 (1958); 3 CUM. BULL. 1008.

155. Pennell, *Planning for the Use of Subchapter S Corporations*, 47 TAXES 746 (1969).

156. *Id.*

157. Kubicek, *Restrictions on the Transferability of Stock*, 43 ILL. B.J. 766 (1955).

158. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 447 (1953).

158a. See article by Wrede Smith, *The Use of Buy-Sell Agreements for the Disposition of an Ownership Interest in a Small Business*.

159. HORNSTEIN, § 176.

160. *Galler v. Galler*, *supra*, footnote 179.

D. Voting Trust

A voting trust is another type of shareholder agreement whereby a number of shareholders can insure control and stability of management. It is a device where a number of shareholders in a corporation do the following:

1. Enter into a written voting trust agreement specifying the terms and conditions of the voting trust;¹⁶²
2. Transfer the legal title and voting rights of their shares to a voting trustee for a period not to exceed ten years, retaining in themselves the other incidents of ownership; and
3. Deposit a counterpart of the agreement with the corporation at its registered office.¹⁶³

VII. EMPLOYMENT CONTRACTS—SHAREHOLDER-EMPLOYEES

Another important agreement in a close corporation is the employment contract.¹⁶⁴ Where stock ownership in a closely held company is disproportionate, it is quite common to have the majority shareholder guarantee the employment of the minority shareholder. An employment contract spelling out the duration of employment, the duties, and the compensation, is advisable especially for an executive employee.

The basic provisions of the employment contract are: (1) the *hiring clause*, which is the provision defining the employee's duties and obligations of performance (willful failure to perform the stated duties or to comply with the employer's instructions in regard thereto will constitute a breach by the employee justifying his discharge);¹⁶⁵ (2) the *term clause* specifying the duration of the contract; (3) the *compensation clause* dealing with salary, reimbursement for expenses, vacations and any other compensation; (4) the *noncompetition clause* protecting the company from unfair competition by the employee;¹⁶⁶ and (5) the *death and disability clause*.

The performance provision of the hiring clause should be broad in scope to afford flexibility in one's employment responsibilities if the need so arises. Since each board of directors has the right to appoint its own president and the other officers provided for in the by-laws of the corporation, an employment contract should not undertake to employ one in such capacity.¹⁶⁷ Instead, the contract should provide for employment "in an executive capacity", or in some other capacity which is not to be filled pursuant to a by-law provision. This approach will help to avoid the question of whether the employment contract is in violation of the by-laws and thus null and void.

161. R. Sprecher, *Organizing Closely Held Corporations*, in ORGANIZING AND ADVISING ILLINOIS BUSINESSES, (Institute on Continuing Education of the Illinois Bar), § 8.5, (1968).

162. Swain, *Voting Trusts in Illinois*, 42 ILL. B.J. 878 (1954).

163. M.B.C.A., § 34.

164. For a more detailed discussion on employment contracts and their form, see MANDEL, THE PREPARATION OF COMMERCIAL AGREEMENTS (1970); G. WASHINGTON AND V. ROTHCHILD, COMPENSATING THE CORPORATE EXECUTIVE (3rd ed., 1962); and, Meck, *Employment of Corporate Executives by Majority Stockholders*, 47 YALE L.J. 1079 (1938).

165. Walsh v. Atlantic Research Associates, 321 Mass. 57, 71 N.E.2d 580 (1947).

166. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625 (1960).

167. MANDEL, THE PREPARATION OF COMMERCIAL AGREEMENTS, at 118 (1970).

The noncompetition clause of the contract is subject to a test of reasonableness. Covenants not to compete must be no more restrictive than necessary to protect the legitimate interests of the company.¹⁶⁸ Short term contracts may not need a provision for disability or death; however, long term contracts should have such provisions.¹⁶⁹

Although such contracts appear to be an enforceable agreement, it is difficult for the employer to prove damages, or to obtain an injunction, or other effective relief against an employee who breaches the contract. The employment contract is often more for the benefit of the employee and represents more of a memorandum of intent rather than an enforceable contract pursuant to which the employee may be compelled to render services.¹⁷⁰

VIII. RESPONSIBILITIES AND LIABILITIES OF DIRECTORS AND OFFICERS

A. General

The board of directors manages the corporation and has responsibility for running the corporation for the benefit of the shareholders.¹⁷¹ Though some jurisdictions permit the authority of directors to be limited in certain areas, this is not the usual pattern. Directors duties include such things as (1) selection and supervision of officers; (2) filling vacancies on the board of directors between meetings of shareholders; (3) authorizing the issuance of shares; (4) declaring dividends; and (5) recommending important actions which must be submitted to shareholders, such as amendments to the articles of incorporation and merger proposals.¹⁷²

B. Duty of Care

Directors must exercise the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.¹⁷³ Thus, directors who turn over control of a business to an officer and do not (1) supervise his conduct,¹⁷⁴ or (2) make reasonable inquiries as to the affairs of the business, or (3) attend meetings on a regular basis,¹⁷⁵ may be liable for certain losses.

C. Duty of Loyalty

In discharging their duties, directors are held to high standards and

168. *National Homes Corp. v. Lester Indiss, Inc.*, 404 F.2d 225 (4th Cir. 1968); *Frederick Chusid & Co. v. Marshall Leeman & Co.*, 279 F. Supp. 913 (S.D. N.Y. 1968).

169. *G. WASHINGTON AND V. ROTHSCHILD, Compensating the Corporate Executive*, (ALIBA), §§ 35-51 (1968).

170. *Id.*

171. M.B.C.A., § 35, *Ill. Bus. Corp. Act* § 33.

172. 2 *W. Fletcher, Cyclopedia of the Law of Corporations*, §§ 265-282 (1969).

173. *Hun v. Cary*, 82 N.Y. 65 (1880); M.B.C.A., § 48.

174. *Gamble v. Brown*, 29 F.2d 366 (4th Cir. 1928), *cert. denied*, 279 U.S. 839, 49 S. Ct. 253 (1928).

175. *Bowerman v. Hamner*, 250 U.S. 504, 39 S. Ct. 549 (1919); *Kavanaugh v. Gould*, 223 N.Y. 103, 119 N.C. 237 (1918). In both instances one or more of the directors charged never attended a director's meeting.

fiduciary principles are applicable. Cases involving the fiduciary duties of an officer or director concern such things as (1) competing with the corporation; (2) usurping corporate opportunities; and (3) oppression of minority shareholders. The fiduciary duty of a director is owed to the corporation and its shareholders, both majority and minority. Any favoritism toward the majority to the detriment of the minority is a violation of the director's duties.¹⁷⁶ Any transaction where an interested director has been involved should be carefully scrutinized for fairness by the entire board as well as the involved director.

Section 10(b) of the Securities Exchange Act of 1934 and Regulation § 240.10(b)(5) promulgated thereunder, commonly known as Rule 10b-5, has developed in recent years to be the legal device whereby officers and directors of even small corporations must account for their improper acts.¹⁷⁷ Rule 10b-5 in general provides a remedy for one damaged by reason of fraud or misrepresentation in a transaction involving the sale or exchange of stock or securities.¹⁷⁸ Almost any purchase or sale of stock can come within the ambit of Rule 10b-5. The mere use of the mail, telephone, or any other instrumentality of inter-state commerce, even if the entire transaction is within the state, will provide the jurisdictional prerequisite for the operation of the rule. Moreover, it is not necessary for a sale to take place on or over a national security exchange to provide a remedy. The liability runs to the one defrauded regardless of whether he was in privity with the person sued.¹⁷⁹

IX. BOOKS AND RECORDS

There are four basic sets of records that each corporation should maintain:¹⁸⁰ (1) an accurate set of financial accounts, organized on uniform accounting principles; (2) a record of the minutes of the directors' and shareholders' meetings; (3) a stock transfer book which is a record of stock ownership and, (4) copies of the articles and by-laws and amendments thereto. Failure to keep separate and proper corporate records may subject directors, officers, and shareholders to liabilities not normally incurred when corporate records are properly kept.¹⁸¹

176. Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957).

177. The ramifications of 10b-5 are still undetermined. Without doubt, however, it applies to "insiders", who, having special information, trade in the securities of the corporation. While the scope of the term "insiders" has not been finally determined, there can be no question that it covers officers and directors of the corporation and other persons with inside information. In this regard, the effect of the statute is to preclude any trading in the corporation's stock by an insider who has failed to disclose inside information. See, e.g., *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D.C. Colo. 1964); *S.E.C. v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

178. Ruder, *Securities Laws—Corporate Disclosures, Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 NW. U.L. REV. 872 (1967) and Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent*, 57 NW. U.L. REV. 627 (1963).

179. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D. N.Y. 1962).

180. See the article by Thom Edmonds in this Journal.

181. *Edward Finch Co. v. Robie*, 12 F.2d 360 (8th Cir. 1926) *accord*, *Majestic Factors Corp. v. Latino*, 15 Misc. 2d 329, 184 N.Y.S.2d 658 (Sup. Ct. 1959) appeal dismissed 187 N.Y.S.2d 1017 (1959), individual liability was imposed here where the "corporation" never

State statutes often direct corporations to maintain business records.¹⁸² However, there is a scarcity of law specifying the time for which records must be maintained. The Social Security Act and the Wage-Hour act require certain employment records to be kept for three years. Because of the shortage of law as to the length of time business records should be preserved, the following are some suggestions. Since the federal tax statute of limitations is six years after the return is filed for gross omissions, a minimum period for retention of financial records should be seven years, and longer if the state tax statute of limitations is longer.¹⁸³ Stock transfer books should be kept for the corporation's life.¹⁸⁴ The minutes, charter and by-laws should be kept for the corporation's life, and thereafter for at least one year beyond the longest statute of limitations applicable to the corporation after its liquidation and dissolution. Intra-office memos and letters that relate to closed matters may normally be reviewed and destroyed after a reasonable period of time, usually 3 years.¹⁸⁵

The importance of keeping accurate and current books becomes quite evident when the business is in the process of attempting to obtain a bank loan or is going to issue stock or bonds to an outside group. As far as outsiders are concerned, the worth of the business can best be ascertained by analyzing the business' financial statements. For example, in reviewing a company's needs, banks and outside investors generally require certified financial statements, including a balance sheet and a profit-and-loss statement, for as many years as possible. Also, many require realistic projections of future operations.¹⁸⁶ It is, therefore, important that the small corporation rely heavily upon the services of professional finance people, e.g., certified public accountants, to keep its books, records, financial statements, etc., in a manner acceptable to lending institutions, outside investors, and the government.¹⁸⁷

The record keeping process should also include detailed financial information on all property, including leased property. In the situation where property is owned, the records should contain a description of the property, its location, value, mortgage and the zoning or building restrictions. Where the property is leased, the records should show the description, location, rent per year and the type of leasing arrangement. All personal property owned by the corporation should also be accounted for in the written records.

functioned as such, i.e., never issued stock, never elected a board of directors, never had shareholder meetings and never filed any returns.

182. *Ill. Bus. Corp. Act*, § 45; *N.Y. Gen. Corp. Law*, § 12 (McKinney).

183. *I.R.C.*, § 6501(e)(1)(A).

184. *M.B.C.A.*, § 30; *ILL. BUS. CORP. ACT*, § 45.

185. *The Uniform Preservation of Private Business Records Act* of 1957 recommends for state enactment a provision which authorizes the destruction of general business records after 3 years, but expressly excepts corporate minutes, 9B U.L.A. 360 (1957).

186. L. Coles, *Financing the Illinois Business*, in *ORGANIZING AND ADVISING ILLINOIS BUSINESSES*, (Institute on Continuing Education of the Illinois Bar), § 2.3 (1968).

187. The Federal Securities Act of 1933 requires that a company present a 3 years' certified profit-and-loss statement before a public offering may be made.

X. TAX REQUIREMENTS

A. Federal Tax Requirements

An immediate problem that has to be resolved by the organizers of the corporation is the election of a taxable year for federal income tax purposes. There are two alternatives. The corporation may elect to report its income on the calendar year or on a fiscal year. In each case, the reporting period cannot exceed 12 months.¹⁸⁸ A new corporation may elect without the prior approval of the Treasury to close its books and file its first federal income tax return as of the close of any of its first 12 months of existence.¹⁸⁹

The year, once selected, may not be changed without the consent of the Internal Revenue Service.¹⁹⁰ If no valid election is made within the time prescribed by law for the filing of the return for the initial taxable year,¹⁹¹ the corporation is relegated to reporting on a calendar year basis.¹⁹² The tax return must be based upon the corporation's books of account.¹⁹³

A corporation may also elect to amortize its organizational expenses ratably over a period of not less than 60 months.¹⁹⁴ To elect this arrangement, a statement of election must be attached to the corporation's return for the taxable year in which it begins business.¹⁹⁵ After any such election, organizational expenses must be treated for accounting purposes as deferred expenses and amortized over the term selected at the date of the election. If a corporation does not elect to amortize its organizational expenses, such expenses are deductible as losses only in the year it liquidates.

The corporation must also elect its accounting method for tax purposes. Generally the corporation will be either an accrual basis taxpayer or a cash receipt and disbursement basis taxpayer.¹⁹⁶

Another vital part of the taxation process is the routine filing and preparation of various tax returns and financial reports. The federal government requires numerous returns, for example: (a) income tax;¹⁹⁷ (b) social security tax; (c) withholding tax;¹⁹⁸ (d) unemployment tax;¹⁹⁹ (e) excise tax;²⁰⁰ and (f) information returns regarding payments of dividends, interest, wages and salaries not subject to withholding, and compensation to independent contractors, including lawyers.²⁰¹ It is very important that the professional help of certified accountants be sought for the preparation of these returns.

188. I.R.C., § 441(f).

189. Treas. Reg., 1.441-1(b)(3)(4).

190. Treas. Reg., 1.442-1(c).

191. Treas. Reg., 1.441-1(b)(3).

192. I.R.C., § 441(g).

193. Treas. Reg., 1.441-1(c).

194. I.R.C., § 248.

195. Treas. Reg., 1.248-1(c).

196. I.R.C., § 446(c).

197. I.R.C., § 6012(a)(2).

198. I.R.C., §§ 3401-3404.

199. I.R.C., § 3501.

200. I.R.C., § 7512.

201. I.R.C., §§ 6041 and 6042.

Also, income tax must be withheld from income paid an employee as long as his wages for any payroll period exceeds the allowance for his withholding exemptions for that pay period.²⁰² The employer is liable for the payment of payroll taxes, i.e., withholding tax, *whether or not* the taxes are collected.²⁰³

B. State Tax Requirements

Persons desiring to incorporate are usually required by the corporate law of the state where they wish to incorporate to pay an incorporation fee for the filing of the articles of incorporation²⁰⁴ and an initial license fee.²⁰⁵ The corporation once established must also pay an annual franchise tax for the privilege of exercising its franchises in the state where it is incorporated.²⁰⁶ If a business is incorporated in one state and transacts business in another, it is subject to the organizational fees and annual franchise tax of the state of incorporation plus a license fee and annual franchise tax in the state where it is transacting business.²⁰⁷ Also, some states may impose a tax on the issuance and transfer of stock.

202. I.R.C., § 3402.

203. I.R.C., § 3403. Additional information on employment taxes and information returns may be obtained from Chapter 27 of Publication number 334 of the Internal Revenue Service entitled, *TAX GUIDE FOR SMALL BUSINESSES* (1974).

204. ILL. BUS. CORP. ACT, § 127(a), says the Secretary of State shall charge and collect \$75 for the filing of the articles of incorporation and the issuance of a certificate of incorporation.

205. ILL. BUS. CORP. ACT, §§ 128-130, imposes an initial license fee of 1/20 of 1 percent of the consideration for the issuance of the corporation's shares.

206. The annual franchise tax in Illinois, for example, pursuant to ILL. BUS. CORP. ACT, § 132, is 1/10 of 1 percent of the sum of the stated capital and paid-in surplus represented in Illinois.

207. ILL. BUS. CORP. ACT, §§ 135-140.

ANNOUNCEMENT

We have purchased the
entire back stock and
reprint rights of —

BLACK LAW JOURNAL

Complete sets to date
are now available. We
can also furnish single
volumes and issues.

WILLIAM S. HEIN & CO., INC.
1285 Main Street
Buffalo, New York 14209