

YEAR-END STOCK SALE ISSUES

For professionals dealing with stock certificates of closely-held businesses

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TABLE OF CONTENTS

	Page
1. There is no title insurance for shares of a closely-held corporation.	1
2. Use a stock assignment; don't sign the back of the stock certificate.....	1
3. The name of the transferor on the stock assignment must match exactly the name on the stock certificate from which the shares are transferred.	2
4. To prepare the stock transfer documents properly, you must have the stock certificates from which the shares are to be transferred.....	2
5. Use pre-printed stock certificates	3
6. Give some thought to the name in which the new shares are issued.	4
7. Prepare the receipt-stub and be sure to have it signed by the holder of the new stock certificate.....	4
8. Use the corporate seal	5
9. Mark "COPY" on each photocopy of a stock certificate	5
10. Cancel or Void?	6
11. The company should have a share register.	6
12. Classes of shares: Numbering certificates.....	6
13. Add appropriate legends to the new stock certificate.....	7
14. Avoid fractional shares	8

15. When the corporation dissolves, collect all the outstanding stock certificates, cancel them and put them in the corporate stock book. 9

ADDITIONAL INFORMATION 11

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This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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- 1. There is no title insurance for shares of a closely-held corporation.**
 - 1.1. Many people handle the stock certificates. When they reach your desk, don't assume that all prior stock transactions were properly documented. Especially if the stock book is in poor shape or there is no stock register.
 - 1.2. If the business was sold, the seller would be required to warrant that he is the owner of the shares, or the company would be required to warrant that its shareholders had properly approved the sale of its assets. That should not be the first time that anyone has considered the issue.
 - 1.3. For companies with poor stock records, it often is necessary to obtain declarations from the long-time officers and directors about who owned shares and when they owned them. It is also necessary to review old tax returns. As time goes on, it becomes more difficult or impossible to collect this evidence, so the sooner the records are reviewed, the more likely an efficient, happy outcome of the review.

- 2. Use a stock assignment; don't sign the back of the stock certificate**
 - 2.1. Deals change. You do not want to void stock certificates if you can help it.
 - 2.2. If the deal might still be in flux, consider having the parties sign all of the documents except the stock certificates, and then prepare

the stock certificates after the parties have signed all the stock transfer documents.

3. The name of the transferor on the stock assignment must match exactly the name on the stock certificate from which the shares are transferred.

3.1. If the name of the transferor is not correct, consider transferring the shares from the old name to the new name of the transferor before the transfer to the new holder.

3.2. A successor trustee can sign the stock transfer as trustee, but the corporation should have a certificate of trustee so that the corporate secretary has some assurance that the person is really the successor trustee.

3.3. If the shares were not in trust when the decedent died, the corporate secretary should obtain a copy of the order of the Probate Court appointing the executor or the order to disburse the shares.

3.3(a) If no executor was appointed because the probate estate was too small, the corporate secretary should obtain a certificate to that effect from the executor.

4. To prepare the stock transfer documents properly, you must have the stock certificates from which the shares are to be transferred.

4.1. Having the original certificate in your hands is ideal.

4.2. If you can only get a copy, be sure you have copies of both the front and the back of the certificate.

4.2(a) You want to know about any legends on the back of the certificate.

- ◆ For example, are the shares subject to a pledge to secure a promissory note? If so, has the note been paid in full?

- ◆ Are there legends required by securities laws?
 - ◆ Do the legends refer to a shareholders or buy-sell agreement? If so, have you seen it?
 - ◆ Is the corporation a close corporation? If so, why?
- 4.3. You need the information on the stock certificate to prepare the stock assignment(s) and the receipt-stubs for the new stock certificates.

4.3(a) The receipt-stub shows the old certificate(s) from which the shares on the new certificate were transferred.

- ◆ This info is necessary to assure that there are not more shares outstanding than the cumulative sum of all of the shares issued less all of the shares redeemed.
- ◆ Rounding when switching partial shares between fractions and percentages can cause the total number of shares outstanding to be more or less than the indicated number of outstanding shares.

5. Use pre-printed stock certificates

- 5.1. It does not inspire confidence in the stock records when you find several signed versions of stock certificate number 18.
- 5.2. The name of the corporation and the number of authorized shares and the name of the class of shares should not vary from certificate to certificate. Using pre-printed shares prevents these inaccuracies (or else makes the inaccuracies uniform, if inaccurate info was given to the printer).

- 6. Give some thought to the name in which the new shares are issued.**
 - 6.1. If the transferee seems like someone who should have a trust (reasonably wealthy with kids, or very wealthy), ask if he has a living trust. If so, ask him to ask his estate planning attorney how he should take title to the shares, or to refer to the “operating manual” letter that the attorney sent to him with his signed trust.
 - 6.1(a) It might be best for the estate planning attorney to create a subtrust in the living trust for business assets of the wife than can be held in her name only as trustee while she is alive and competent.
 - 6.1(b) Even if the couple does not have a subtrust and creating one is not feasible, consider issuing the shares in the name only of the spouse who is involved in the business.
 - 6.2. If the shares were in wife’s name, and the trust requires that the couple hold title as co-trustees, consider the effect on the other shareholders if the wife and husband vote their shares differently, as co-trustees. The conflicting votes of the spouses will cancel each other out.
- 7. Prepare the receipt-stub and be sure to have it signed by the holder of the new stock certificate.**
 - 7.1. The holder retains the original stock certificate and the company retains the signed receipt-stub in the stock book.
 - 7.2. The signed receipt-stub is often the only evidence that the shares were actually issued and received by the person named on the stock certificate.
 - 7.3. Having the signed receipt-stub is especially important if the holder loses the stock certificate. The signed stub allows the corporate secretary to be sure that the stock was really issued to the person who says that they lost the certificate and who is demanding a replacement stock certificate.

- 7.4. The receipt-stub should identify the stock certificates from which the shares are being transferred to the new stock certificate.
 - 7.4(a) To do this, you will need the old certificates in your hands, as well as a good share register.
- 7.5. The receipt-stub should bear all of the legends on the stock certificate.
 - 7.5(a) Without this, the company will not know what legends were on the certificate. This will be important if a certificate is requested to replace a lost stock certificate.
 - 7.5(b) There might be copies of the stock certificate, but if they are in the attorney's files, they might not be signed by the officers or the holder. Also, a buyer's attorney or a new corporate attorney might not have access to the prior attorney's files. So it is best to keep a tidy stock book.

8. Use the corporate seal

- 8.1. A corporate seal is not legally required, at least for California corporations. However, it is possible to make really, really good color photocopies and .pdf copies of stock certificates. The three-dimensional seal might be the only thing that allows anyone to determine which copy is the original.
- 8.2. If the seal is lost, get a new one. If it's a hassle to get it from the company, buy a new one for the attorney's office.
- 8.3. Don't impress the seal on any photocopies of the stock certificates!

9. Mark "COPY" on each photocopy of a stock certificate

- 9.1. This includes copies in correspondence files and in bound volumes, or the .pdf copies on a CD.

9.2. You do not want to be the one who set the stage for an expensive and protracted controversy over which certificate was authentic.

9.3. Do the same for copies of checks and promissory notes.

10. Cancel or Void?

10.1. If the stock certificate was prepared, but was never signed by the officers, and the company decides not to issue it after all, the word "VOID" should be written or stamped across the face of the stock certificate.

10.2. The canceled or voided stock certificate should be returned to the stock book by attaching the certificate to its receipt-stub.

10.2(a) The certificates should never be destroyed!

11. The company should have a share register.

11.1. The share register shows when each stock certificate was issued, to whom and for how many shares, whether it was an original issuance by the corporation or a transfer from another certificate.

11.2. The register is typically maintained in Excel.

11.3. The register can also show quickly how many shares are outstanding and how many shares each shareholder owns.

11.4. Update the share register for each transaction. It is going to be a lot more difficult to update a year later, or whenever the next share transaction is contemplated.

12. Classes of shares: Numbering certificates

12.1. If the corporation had one class of shares initially, and then amends its articles to have both voting and non-voting shares, the voting certificates should continue in the sequence from the origi-

nal capital shares and the non-voting shares should start a new sequence (at Non-Voting stock certificate number 1).

12.2. If the shares are divided into classes and no class is a clear successor to the original capital stock, start the numbering sequence for all classes over at certificate number 1.

12.3. The receipt-stub must indicate the class of shares represented by the stock certificate to which it refers. Also, the “transferred from” section of the receipt-stub should indicate the class of shares, using a consistent abbreviation convention.

12.3(a) Examples: “21V” and “21NV” to indicate voting or nonvoting shares, with “21” being the number of the stock certificate for that class of shares.

12.4. It is not possible for a holder of all voting shares to transfer non-voting shares. His transferee gets voting shares. And vice-versa.

12.4(a) If the goal is for the transferee to have non-voting shares, the transferee must first receive voting shares and then exchange them with the corporation for non-voting shares (if the articles of incorporation authorize any non-voting shares).

13. Add appropriate legends to the new stock certificate

13.1. Examples: Buy-sell agreement, shareholder agreements, pledged shares, close corporation status, securities laws.

13.2. Generally, if the certificate from which the shares are transferred had a legend, the new stock certificate probably should also have the legend.

13.2(a) An exception is the 25102(h) legend about getting the Commissioner of Corporation’s approval to transfer the shares. Generally, that need not be on the new certificate and the approval need not be obtained.

13.2(b) Do the bylaws include restrictions on the transfer of shares? If so, consider adding a legend even if the bylaws do not require it.

14. Avoid fractional shares

14.1. If the corporation has too few shares outstanding, then routine transactions will require transfers of fractional shares.

14.2. Fractional shares cause record-keeping problems. The need for fractional shares is an indication that there are too few shares outstanding. You are the only one who can identify or fix that problem.

14.3. When you are finished with the transaction, try to have the value per share around \$15.00 per share. This leaves plenty of shares for the estate planning of the shareholders.

14.3(a) If there are sufficient shares authorized in the articles of incorporation, the corporation can issue a stock dividend to increase the number of outstanding shares, thereby reducing the value per share.

14.3(b) If there are not sufficient shares authorized, the articles of incorporation should be amended to increase the number of authorized shares to accommodate possible future increases in the value of the enterprise.

- ◆ In the amendment, the outstanding shares can be converted into more shares.

14.3(c) After the stock split or stock dividend, an even number of shares should be outstanding (100,000 or 1 million, for example). This will make it easy for the shareholders and their advisors to calculate their percentage interests.

- ◆ It's OK if the stock split factor or the number of new shares issued per share is a wildly uneven number, as long as no partial shares are issued.
- ◆ In a stock split effected by an amendment to the articles of incorporation, it is necessary to provide in the amendment for the fractional shares. I generally provide for cash to be paid for fractional shares.
- ◆ When shares are issued or redeemed, the number of outstanding shares will cease to be round, but that's not a reason to use a round number when possible.
- ◆ The amendment can be an opportunity for other housekeeping, such as restating the articles in one document to include all amendments currently in effect, conforming a pre-1977 California corporation to the 1977 Corporations Code, limiting the liability of directors and maximizing the ability to indemnify officers, directors, employees and agents, and/or abandoning close corporation status if it is not used to vary a specific corporate rule.

15. When the corporation dissolves, collect all the outstanding stock certificates, cancel them and put them in the corporate stock book.

15.1. If the shareholders keep their stock certificates, then years from now, the executor of the estate of a current shareholder will find the stock certificate in the shareholder's safe. The executor might spend a long time trying to verify whether the stock has any value. Collecting the certificates at dissolution will minimize this problem.

15.2. It is possible that after the dissolution a shareholder will want to prove the number of shares he held at the dissolution and the number of outstanding shares at that time. If the shareholder requests it, the corporate secretary can provide a certificate of sec-

retary attesting to these things, in exchange for the stock certificate.

15.3. The corporate secretary should keep the stock book permanently.

[End of outline.]

ADDITIONAL INFORMATION

To receive more information about these issues, please check the box(es) below, provide your address (or business card) and return this page to Bill Staley - or FAX it to Susan Rognlie at (818) 936-2990.

1. **“Buy-Sell Agreements for Owners of Closely-Held Businesses: An Overview”***
2. **“Buy-Sell Agreements: Life Insurance Issues”***
3. **“C2S: The S Corporation Election for an Existing C Corporation”***
4. **“Choice of Business Entity: Structuring Businesses for the Recovery” ***
5. **“Dissolving Business Entities and Corporate Housekeeping” ***
6. **“Limited Liability Companies: An Introduction”***
7. **“S Corporations – The Nuts and Bolts” ***
8. **“Secret Techniques of a Tax and Business Attorney”***
9. **“Succession Planning - Transferring a Business to the Next Generation” ***
10. **“Large Charitable Contributions - Private Foundations, Charitable Lead Trusts and Community Foundations” ***

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* Available on www.staley.com.