Maurer School of Law: Indiana University
Digital Repository @ Maurer Law

Indiana Law Journal

Volume 25 | Issue 1 Article 4

Fall 1949

Restrictions on the Alienation of Shares of Stock

Follow this and additional works at: http://www.repository.law.indiana.edu/ilj

Part of the Securities Law Commons

Recommended Citation
(1949) "Restrictions on the Alienation of Shares of Stock," *Indiana Law Journal*: Vol. 25: Iss. 1, Article 4.
Available at: http://www.repository.law.indiana.edu/ilj/vol25/iss1/4

This Note is brought to you for free and open access by the Law School Journals at Digital Repository @ Maurer Law. It has been accepted for inclusion in Indiana Law Journal by an authorized administrator of Digital Repository @ Maurer Law. For more information, please contact wattn@indiana.edu.

JEROME HALL LAW LIBRARY
INDIANA UNIVERSITY
Maurer School of Law
Bloomington

NOTES

CORPORATIONS

RESTRICTIONS ON THE ALIENATION OF SHARES OF STOCK

How to prevent a shareholder from selling his interest to an unwelcome outsider has long been a problem to the founders of closely held corporations. Shareholders of this type corporation usually operate in intimate contact with each other, and the stock is sold not so much to raise money as to bring into the corporation capable personnel. A new shareholder without special ability and with only an investment interest may be a real detriment. Interested only in the regular payment of dividends, his dissention is likely to be disruptive of the policy of the remaining shareholders.

An attempted solution of this problem recently came to the attention of the Delaware courts. Tracey and Franklin, majority holders of a single class of stock in a Delaware corporation, agreed to form a voting trust to enable unified action in exercising the rights and privileges of shareholders. To strengthen this agreement, each covenanted not to sell or attempt to sell his shares deposited with the trustees, nor assign or sell his voting trust certificates, save with the written consent of the other party. Franklin became recalcitrant, and Tracey sued to prevent him from voting his shares in violation of the trust agreement. The defense was illegality of the covenant in that it constituted an unreasonable restraint on the privilege of free alienation of property The question of legality turned upon the reasonableness of the restraint in the light of the needs of the corporation,[1] and the evidence failed to show any corporate need for such a restraint. Indeed, the restraint was found not to have been imposed for the benefit of the corporation, but rather for the exclusive benefit of the two shareholders. Further, the operation of the restraint prevented sale of stock during the life of the voting trust, a period of almost ten years. In view of the lack of corporate purpose and the stringency of the restraint itself, the court found the restriction was neither reasonable in operation nor necessary to the corporation. Franklin's motion to dismiss was granted. *Tracey v. Franklin*, 61 A.2d 780 (Ch. Del. 1948), *aff'd*, 67 A.2d 56 (Sup. Ct. Del. 1949)

Some restriction upon the alienability of corporate shares of stock is the scheme most often utilized to exclude all except approved shareholders from the stock lists of close corporations. These restrictions are of two general types Those which give the corporation or the shareholders the first opportunity to buy when a sale is desired by the shareholder, hereinafter called

1. Twice before the Delaware court passed upon the legality of stock transfer restraints. Green v. Rollins & Sons, 22 Del. Ch. 394, 2 A.2d 249 (1938), Lawson v. Household Finance Corp., 17 Del. Ch. 343, 152 Atl. 723 (1930).

"first option";[2] those which absolutely prohibit the sale of stock without the consent of the remaining shareholders or the corporation, hereinafter called "consent" restraint.[3] Such restraints may be used to good advantage in every close or family corporation and the conditions under which these restraints may be imposed and the method of imposition are matters of importance to the practicing attorney. This discussion will be directed to the problems of drafting such restrictions and to their probable validity.

The first option restraint is most frequently adopted to control the admission of new shareholders.[4] Often the restraint extends the option to both the shareholders and the corporation, thus further strengthening the control.[5] A shareholder desiring to sell stock held under this option is commonly required to offer the shares to the corporation or the shareholders at the price at which a bona fide purchaser will buy.[6] The agreement, however, may call for sale at book or par value,[7] and restrictions containing such provisions have been upheld despite the opportunity of the shareholder to sell at a higher price.[8]

When first option agreements were first litigated they were almost always held invalid as an unreasonable and arbitrary restraint on alienation.[9] But the need for some method to insure workable control in the corporation was recognized by Mr. Justice Holmes soon after the turn of the century and his opinion in *Barret v. King*,[10] stressing the personal relationship of shareholders in closely held corporations, did much to gain for these selective restraints the

---

2. *E.g.*, Gibbon v. 3920 Lake Shore Drive Bldg. Corp., 310 Ill. App. 385, 34 N. E.2d 109 (1941); Touchet v. Touchet, 264 Mass. 499, 163 N. E. 184 (1928); State v. Sho-Me Power Co-op., 204 S. W.2d 276 (Miss. 1947); Elson v. Schmidt, 140 Neb. 646, 1 N. W.2d 314 (1941); Baumohl v. Goldstein, 95 N. J. Eq. 597, 124 Atl. 118 (1924); Oppenheim Collins & Co. v. Beir, 187 Misc. 428, 64 N. Y. S.2d 19. (1946).

3. *E.g.*, Mason v. Mallard Telephone, 213 Iowa 1076, 240 N. W. 671 (1932); 68 Beacon Street v. Sohier, 289 Mass. 354, 194 N. E. 303 (1935); Brown v. Little, Brown & Co., 269 Mass. 102, 168 N. E. 521 (1929); Penthouse Properties v. 1158 Fifth Ave., 256 App. Div. 685, 11 N. Y. S.2d 417 (1939); Citizens Bank of Houston v. O'Leary, 140 Tex. 345, 167 S. W.2d 719 (1942).

4. A typical example of such a restriction is: "The right to assign or transfer the common stock of the company shall be subject to the company's option of purchase from the stockholder of record within 20 days on written notice of the desire of such shareholder to sell, assign or transfer the same." Baumohl v. Goldstein, 95 N. J. Eq. 597, 600, 124 Atl. 118, 119 (1924).

5. *E.g.*, Stern v. Stern, 146 F.2d 870 (App. D. C. 1945); Vannucci v. Pedini, 217 Cal. 138, 17 P.2d 706 (1932); Searles v. Bar Harbor Banking & Trust Co., 128 Me. 34, 145 Atl. 391 (1929); Elson v. Schmidt, 140 Neb. 646, 1 N. W.2d 314 (1941).

6. Gibbon v. 3920 Lake Shore Drive Bldg. Corp., 310 Ill. App. 385, 34 N. E.2d 109 (1941); Oppenheim Collins & Co. v. Beir, 187 Misc. 428, 64 N. Y. S.2d 19 (1946).

7. *E.g.*, Evans v. Dennis, 46 S. E.2d 122 (Ga. 1948); Chaffee v. Farmers Co-op. Elevator Co., 39 N. D. 585, 168 N. W. 616 (1918).

8. Elson v. Schmidt, 140 Neb. 646, 1 N. W.2d 314 (1941).

9. Bloede v. Bloede, 84 Md. 129, 34 Atl. 1127 (1896); Brinkerhoff-Farris Trust & Saving Co., 118 Mo. 447, 24 S. W. 129 (1893).

10. 181 Mass. 476, 63 N. E. 934 (1902).

almost universal recognition which they now enjoy.[11] Although several decisions have assumed the option restraint valid without discussion,[12] the majority of the courts analyze the circumstances giving rise to the particular restraint to ascertain its validity.[13] The prime consideration is the reasonableness of the restraint in the light of the character and need of the corporation. In *Lawson v. Household Finance Corporation*[14] a first option accompanying a voting agreement contract was held valid since its purpose was to aid in assuring good management and effective control in a closely held corporation, the success of which was dependent upon the ability of the shareholders. Such restrictive agreements are well adapted to insure smooth control in close corporations.[15]

The consent restraint requires the shareholders desiring to sell to secure the approval of the remaining shareholders or the board of directors. This restriction is employed to meet a different situation than that which occasions the use of the first option. For example, the corporate founders might want to exclude outsiders and at the same time avoid tying up corporate funds in the purchase of treasury shares, as might be necessary under the option restraint. By requiring consent to be secured before a sale, the restriction compels the original shareholder to fulfill his obligation to the corporation until a suitable replacement can be found.[16]

In regard to consent restraints, the decision in the *Tracey* case is in accord with the law as it was understood and applied shortly after the turn of the century. Until 1914, almost without exception, the courts held that any restraint conditioning the ability of the owner to sell his stock upon the consent

---

11. Thus, the following passage from the *Barrett* case, quoted in Serota v. Serota, 168 Misc. 27, 30, 5 N. Y. S.2d. 68, 71 (1938), was relied upon in holding valid an option agreement: ". . . stock in a corporation is not merely property. It creates a personal relationship analogous otherwise than technically to a partnership . . . there seems to be no greater objection to retaining the right to choose one's associates in a corporation than in a firm."

12. Monotype Composition v. Kiernan, 319 Mass. 456, 66 N. E.2d 565 (1946); Touchet v. Touchet, 264 Mass. 499, 163 N. E. 184 (1928).

13. Lawson v. Household Finance Corp., 17 Del. Ch. 343, 152 Atl. 723 (1930); Gibbon v. 3920 Lake Shore Drive Bldg. Corp., 310 Ill. App. 385, 34 N. E.2d 109 (1941); Doss v. Yingling, 95 Ind. App. 494, 172 N. E. 801 (1932); Chaffee v. Farmers Co-op. Elevator Co., 39 N. D. 585, 168 N. W. 616 (1918).

14. 17 Del. Ch. 343, 152 Atl. 723 (1930).

15. Conversely, where an open corporation is involved, the shareholders themselves usually have little control; stock is bought for investment purposes, and the only protection the owner has when the corporation is operated in a manner he deems to be adverse to this interest is to sell out. In this situation there would be little reason to hold valid any restraint that tended to prevent a ready sale at the most advantageous price. Few cases have been found involving restrictions employed by open corporations, probably because such controls are generally unnecessary. *See* Ireland v. Globe Milling Co., 21 R. I. 9, 41 Atl. 258 (1898) *passim.*

16. This feature makes the restraint useful to co-operative organizations. *E.g.*, 68 Beacon Street v. Sohier, 289 Mass. 354, 194 N. E. 303 (1935); Penthouse Properties v. 1158 Fifth Ave., 256 App. Div. 685, 11 N. Y. S.2d 417 (1939).

of some other person was invalid as against public policy. Thus, in *In Re Petition of Klaus,*[17] shareholders attempting to invoke such a restraint against a fellow shareholder were unsuccessful though the corporation was composed of only a few members and the shareholder who sought to sell had voted to create this restriction in the by-laws. The Massachusetts case of *Longyear v. Hardman,*[18] decided in 1914, was one of the first instances of judicial approval of this type of restraint. Since then there has arisen an impressive line of cases upholding the subjection of the privilege to sell to the approval of the remaining shareholders or the corporation.[19] In all of these cases special circumstances have made it necessary that the directors and shareholders be able to act together in harmony. The corporation has been a small closely held concern engaged in a limited or special kind of activity. *68 Beacon Street v. Sohier*[20] is typical of one group of cases in which the restraint was found necessary and reasonable. 68 Beacon Street was a corporation organized to operate an expensive and highly exclusive apartment building. The shareholders were tenants holding long term leases to various apartments in the building. To insure that a prospective new tenant, who was also required to be a shareholder, would not detract from the value of the property, the restriction reserved in the directors the right to approve or disapprove of the financial status and character of all possible purchasers. This was held to be a reasonable restraint by the court. Similarly, corporations engaged in the publication of a foreign language newspaper,[21] in the operation of a small town telephone exchange,[22] and in the carrying on of a family operated salvage business[23] have all been successful in the enforcement of restrictions involving consent to a sale.

In deciding which of the two types of restraints, consent or first option, is to be used in the individual case, consideration should be given to the requirements of the corporation and the probable validity of the chosen restraint in the particular jurisdiction. The first option type is the more easily defended against attacks of unreasonableness and, in most instances, will serve to give the shareholders the degree of protection they desire. While there is an apparent trend toward more general recognition of the consent restraint; nevertheless, its validity in some jurisdictions is questionable. Many courts

17. 67 Wis. 401, 29 N. W. 582 (1886).
18. 219 Mass. 405, 106 N. E. 1012 (1914).
19. People v. Galakis, 233 Ill. App. 414 (1924); Mason v. Mallard Telephone Co., 213 Iowa 1076, 240 N. W. 671 (1932); 68 Beacon Street v. Sohier, 289 Mass. 354, 194 N. E. 503 (1935); Brown v. Little, Brown & Co., 269 Mass. 102, 168 N. E. 521 (1929); Penthouse Properties v. 1158 Fifth Ave., 256 App. Div. 685, 11 N. Y. S.2d 417 (1939).
20. 289 Mass. 354, 194 N. E. 303 (1935).
21. People v. Galakis, 233 Ill. App. 414 (1924).
22. Mason v. Mallard Telephone Co., 213 Iowa 1067, 240 N. W. 671 (1932).
23. Oakland Scavenger Co. v. Gandi, 51 Cal. App.2d 69, 124 P.2d 143 (1942).

still regard shares of stock as just another class of personal property and believe public policy demands their free flow in the stream of commerce.

From the decided cases, bits of information can be gleaned which, when assembled, give valuable aid in drafting restrictive agreements of both types. On general corporation principles, a provision in the articles of incorporation is held binding as a contract to which each shareholder is a party.[24] Thus, any restraint upon alienation should be drafted in the articles when the corporation is formed.[25] In addition, since the courts lay major stress on reasonableness in upholding the restraint, it is advisable to detail the corporate interests requiring the application of the restraint. Where the restraint is adopted after incorporation, it would be advisable to amend the articles to include the provision.

In addition to writing the sale restriction in the articles, a by-law should be adopted augmenting them.[26] Courts that have found a provision in the articles invalid for lack of statutory authority have upheld the restraint as a binding contract between the corporation and the shareholders, or between

---

24. "Ever since the decision in the *Dartmouth College Case* . . . it has been generally recognized in this country that the charter of a corporation is a contract between . . . the corporation and its shareholders. It is not necessary to cite authorities to support this proposition." Lawson v. Household Finance Corp., 17 Del. Ch. 343, 349, 152 Atl. 723, 727 (1930).

25. Inclusion in the articles is apparently not required in Indiana, in view of section 6(g) of the Indiana Corporation for Profits Act, IND. STAT. ANN. (Burns 1933) § 25-206, which provides that the transfer of stock may be regulated by appropriate provisions in the by-laws. However, good corporate practice mandates this inclusion. An example of such an article provision follows:

> No transfer of stock shall be valid, until ten days after the company, through its secretary, shall have written notice of the proposed sale, the price at which the proposed sale is to be made, and the name of the prospective buyer; and during said ten days, the company shall have the sole option to buy the said shares at the price named in the notice.

26. There has been little litigation in Indiana on the validity of restraints on the alienation of shares of stock. In Doss v. Yingling, 95 Ind. App. 494, 172 N. E. 801 (1932), a first option restraint imposed in the by-laws was held binding upon the shareholders. The court refused to pass upon the legality of the by-law, but ruled that in any event the agreement would be binding as a contract, evidenced by the by-laws. A typical by-law provision for a restraint reads as follows:

> If any stockholder desires to sell his stock in such company, the remaining stockholders of such company shall have the first right to purchase the same in the proportions of their present holdings in such company, and the price to be paid for such seller's stock shall be the value of the same as shown by the books of the company at the time of the proposed sale. Such retiring or selling stockholders shall give the other stockholders notice in writing of his intention to sell his stock, and such remaining stockholders shall have ten (10) days from the receipt of such notice within which to purchase such stock at its book value; but if they, or any of them, do not exercise the right to purchase then such selling stockholder is at liberty to sell such stock to third persons. If any stockholder does not desire to avail himself of the privilege to purchase such stock as herein provided, then the other stockholders may exercise such privilege in the proportions of their present holdings.

the shareholders themselves, where it also appeared in the by-laws.[27] Thus, it was said in *Searles v. Bar Harbor Banking and Trust Co.*,[28] ". . . we think that the tendency of the more recent decisions . . . is to sustain such restrictions if reasonable and the stock has been accepted following the adoption of the restriction . . . whether valid as a by-law or not on the ground that it constitutes a valid agreement between the shareholders and the corporation." The quotation suggests that, as to those shareholders acquiring shares before the restrictive agreement was adopted, the restraint would not be binding. The same would seem true as to those holders who did not vote to adopt the by-law. In either situation, to apply the restraint to the dissenter would result in changing the contractual rights acquired by the shareholder under the terms of the original purchase agreement. However, it is possible that these contract rights could be validly changed by an amendment to the articles. Such amendments, when passed by the required vote, generally are binding upon all shareholders, whether they voted for or against them.[29]

If a restraint is imposed neither by the articles nor the by-laws, but by a private contract between the shareholders, it may still be binding. The danger in the private contract method lies in the difficulty of proving the restraint reasonable, for where the restraint is not imposed by the corporation the inference is that the corporate organizers did not consider such a restraint necessary. However, if substantial need for the restraint can be shown the private contract is likely to be as binding as a by-law or article provision.[30]

The Uniform Stock Transfer Act[31] requires notice of any provision affecting the free alienation of shares of stock to be printed on the stock certificate if it is to control subsequent sales by the shareholders. Whether or not the jurisdiction in which the business is incorporated has adopted the Uniform Stock Transfer Act or a similar provision, it is advisable to have such notice printed on the certificate, rather than rely on the implied notice to purchasers that arises from the articles and by-laws.

Some consideration should be given to the duration of the restraint. The problem applies particularly to the consent restraint. Here, if the corporation withholds consent to sell, the shareholder would be prevented forever from

---

27. *See* Doss v. Yingling, 95 Ind. App. 496, 501, 172 N. E. 801, 803 (1932); Krauss v. Kuechler, 300 Mass. 346, 349, 15 N. E.2d 207, 209 (1938).

28. 128 Me. 34, 39, 145 Atl. 391, 393 (1929).

29. Section 28 of the Indiana Corporation for Profit Act; IND. STAT. ANN. (Burns 1933) § 25-227 provides that an amendment shall not affect ". . . the existing rights of persons *other than shareholders*. . . ." By implication, the statute does permit the rights of a shareholder to be changed by an amendment. (Italics added). *See* Mason v. Mallard Telephone Co., 213 Iowa 1076, 1080, 240 N. W. 671 673 (1932).

30. Model Clothing House v. Dickinson, 146 Minn. 367, 178 N. W. 957 (1920); Oppenheim Collins & Co. v. Beir, 187 Misc. 428, 64 N. Y. S.2d 19 (1946).

31. Section 15. This provision has been adopted in Indiana. IND. STAT. ANN. (Burns 1933) § 25-715.

disposing of his stock; whereas stock held subject to the first option may be sold at the expiration of the period during which the corporation has the privilege to buy. The fact that duration is usually unlimited seldom appears to influence the courts final decision. The *Tracey* case is one of the few instances where the court considered this factor, and yet here the implication was strong that had there been a showing of corporate need the restraint would have been valid.[32] In general, it may be said that the needs of the corporation should control the duration. For example, if the restraint is imposed to preserve the family character of a corporation, it must retain its force so long as that character remains unchanged. In drafting, therefore, it should be specified that the restraint will be applicable so long as the corporation retains its original character.

What has been said above applies both to the first option and consent restraints. There remain to be considered two factors which have application exclusively to the first option.

In exercising the granted option the corporation acquires the shares from the holder; thus, it is imperative that the provision establishing the option provide for the fixing of a purchase price. Probably the most suitable method of determining this price is by the valuation of an arbitration committee, one member of which is appointed by the corporation, one by the shareholder, and these two to select an impartial third member. This enables the shareholder to secure a more adequate return over book value, and at the same time reserves to the corporation some voice in the fixing of the price. For the shareholder who can find no willing buyer, such a valuation is necessary since the stock of small corporations is not listed on the exchanges and there is no readily ascertainable market value.

A well drafted first option agreement should contain a definite statement of the period during which the corporation has the option to buy after receiving notice of the desire to sell. Although it is probable no restriction has been struck down because of the absence of this condition, the inclusion of it will prevent disputes between the parties as to when the shareholder is free to sell to an outsider. There must be time for the directors to meet, to determine whether or not to exercise the option, and to procure the necessary funds to purchase the shares. The latter may be no small problem to the typical closely held corporation. The legality of the duration of the option period itself has never been litigated. In one case, however, a restraint involving an option of

32. *See* 67 A.2d 56, 59-60 (Sup. Ct. Del. 1949).

ninety days[33] was held valid, and numerous options of from thirty to sixty days[34] have been upheld.

Restraints of the types discussed can be extremely useful to the small corporation, and careful consideration should be given to the advisability of their inclusion as part of the agreement between the shareholders and between the shareholders and the corporation. The first option restraint, when properly imposed, is almost certain to be upheld by the courts as against attacks of unreasonable restraint on alienation. The degree of certainty is less for the consent restraint, but the utility of it in special circumstances would seem to warrant the risk.

---

33. Chaffee v. Farmers Co-op Elevator Co., 39 N. D. 585, 168 N. W. 616 (1918).

34. Model Clothing House v. Dickinson, 146 Minn. 367, 178 N. W. 957 (1920); State v. Sho-Me Power Co-op., 204 S. W.2d 276 (Miss. 1947); Serota v. Serota, 168 Misc. 27, 5 N. Y. S.2d 68 (1938); Nicholson v. Franklin Brewing Co., 82 Ohio St. 94, 91 N. E. 991 (1910); Rychwalski v. Milwaukee Candy Co., 205 Wis. 193, 236 N. W. 131 (1931).