THE CLOSE CORPORATION AND STOCK TRANSFER RESTRICTIONS *

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The special attributes of close corporations

When the U.P. Law Center committee which prepared the original draft of the proposed Corporation Code decided to include provisions on close corporations, it faced the problem of whether or not to define a "close corporation." The alternative to defining it was to include special provisions which would recognize the validity of particular acts or contracts peculiarly suited only to close corporations. After deciding on the first alternative, the committee was confronted by the much more difficult task of properly defining what a close corporation is.[1] This is not easy for even the various definitions which have been used from time to time by the different American courts are not completely satisfactory. For the purposes of this paper, rather than adhering to any set definition, perhaps it would be best to identify instead the usual attributes of a typical close corporation: (1) it has only a few stockholders, who if not related by blood or marriage, know each other well and are aware of each other's business skills; (2) all or most of them are active in the corporate business, either as directors, officers or as key men in management; and (3) the stocks of the corporation are not listed on the exchange nor is there trading in them outside the stock market.[2] Judging by these attributes, it would perhaps not be an exaggeration to state that a great majority of Philippine corporations are close corporations. It would thus be for the benefit of anyone who intends to engage in corporate law practice to acquaint himself with some of the problematic areas within which close corporations operate.

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[1] Sec. 127 of the original draft of the Proposed Corporation Code defines it thus: "A close corporation, within the meaning of this Code, is one wherein at least two-thirds of the voting stock or voting rights is owned or controlled by one individual or one family or group, or where the transfer of stock or rights therein is limited or restricted to or among the existing stockholders or members where their number does not exceed fifty."

[2] See 1 O'NEAL, CLOSE CORPORATIONS 13 (1958).

The existence of close corporations can be attributed to the desire of intimate groups of business associates to obtain the advantages of a corporate organization, like that of limited liability. However, the identity and personality of each shareholder are important to his associates, so that although they may consider their business as a corporation in their dealings with third persons, among themselves the stockholders act and feel as partners. Thus a close corporation has been described as a "corporation *de jure* and a partnership *de facto*" and has been often referred to as an "incorporated partnership." A close corporation then has special needs different from those of a widely held corporation, and in many situations it would not be fair nor practical to apply to both kinds of corporations indiscriminately the same principles of law.

In England, the need to apply special rules to close corporations has long been recognized by statute.[3] Similarly, the law in West Germany grants the close corporation more flexibility with which it is permitted to conduct its affairs.[4] Although originally American statutes had for the most part laid down rather inflexible rules equally applicable to both closely and widely held corporations, more recent statutes have been enacted in many states precisely to meet the special problems of close corporations.[5] Likewise, most American courts have long ago recognized the difference between the two and have upheld acts or contracts of close corporations and its shareholders which would otherwise have been struck down as void if done by or within a widely held corporation.

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[3] See Grower, *Some Contrasts Between British and American Corporation* Law, 69 HARV. L. REV. 1369, 1376 (1956). He states in part: "Whereas the American statutes tend to lay down mandatory rules, the British Companies Act relies far more on the technique of the Partnership Act, providing a standard form which applies only in the absence of contrary agreement by the parties. Much that in America is mandatory is in Britain included only in the optional model constitution—the famous table A. And this constitution, or whatever the parties substitute for it, is expressly declared by the act to bind the company and the members as if it were a contract under seal. In particular this contractual constitution deals with the method of appointing the directors, with a division of powers between them and the stockholders, and, subject to important exceptions, with the meetings and votes of each. In America these matters have generally been fixed by statute, and fixed a way which shows that the draftsmen envisaged their application to publicly owned corporations. It is unnecessary to detail the difficulties which these 'statutory norms' have caused to those wishing to provide added safeguards perfectly reasonable in the case of close corporations."

[4] See Haskell, *The American Close Corporation and Its West German Counterpart: A Comparative Study*, 21 ALA. L. REV. 287 (1969).

[5] E.g., Del Code Ann., tit. 8, sec. 102(b) (1) and (b) (4); Ark. Stat. Ann., sec. 64-101(i); Florida Stat. Ann., sec. 608, 03; Georgia Code Ann., sec. 17-2803 (B); Maryland Ann. Code, art. 23, sec. 4(b)(9); Mich. Stat. Ann., sec. 21.4(2); New Jersey Re. Stat., sec. 14:2-3; West Va. Code Ann., sec. 301(g); N.Y. Gen. Corp. Law, sec. 9 and sec. 13 (2); Illinois Ann. Stat. c. 32, sec. 157, 148; Ohio Rev. Code Ann., sec. 1701, 55; Wis. Stat., sec 180.51, 180.64, 180.71. The Model Business Corporation Act has several provisions intended for close corporations.

Our Corporation Law, patterned as it was after early American law, has only one set of rules applicable to all corporations alike, and close corporations have to struggle within this rigid legal framework to make suitable provisions in their articles of incorporation or by-laws to meet their peculiar needs. Whether or not the idea in the original draft of the proposed Corporation Code of treating close corporations differently will be accepted by our lawmakers still remains to be seen.

It may be argued that the close corporation is an incongruity in the New Society, which has fostered the idea of dispersal of wealth and of widening the base of ownership in corporations. To be sure, this is a laudable and most welcome policy. It should be emphasized however that this is aimed at big business and businesses affected with public interest, and seeks to prevent monopolistic situations specially in some sensitive areas of industry. It is not intended to discourage, much less prevent, all and sundry to invest in their own legitimate private ventures, no matter how modest, as a means of living and of securing their future and that of their children.

Need for stock transfer restrictions in close corporations

Under the Corporation Law, the management of a corporation is vested in its directors. Although they are chosen by the stockholders, once elected, they act independently of such stockholders, notwithstanding the fact that the latter are the owners of the interests in the corporation. In a widely held corporation, this in fact is the situation—management is usually divorced from ownership. Thus, when a stockholder becomes dissatisfied with management, it is only fair that he should be completely free, if he wishes, to get out of the business by selling his share in the market, subject to no restraint or restriction whatsoever.

In a close corporation, however, the situation is quite different. Formed by persons who know each other well, ownership and management are usually vested in the same people. Most, if not all, of the stockholders are participants in policy decisions which are usually made with the minimum of formality, without all the proceedings which a widely-held corporation would normally follow. They would thus be wary about any stranger coming into the business and will want to choose the persons who will be allowed to join their intimate group. There may be a host of reasons for keeping out strangers—lack of trust and confidence, lack of congeniality with members of the group, its necessity to the attainment of corporate goals, protection from competitors who want to get in, unwillingness to pay salaries or even substantial dividends to a stockholder who contributes no effort to the acquisition of corporate profits, the possible friction which may come from a non-active shareholder who may question the salaries paid to the active ones, and other areas of conflict which may lead to expensive litigation and possible loss of good will. Considering these special circumstances attending a close corporation, it is oftentimes justifiable, and at times imperative, for its stockholders to protect themselves from future conflicts by placing restrictions on the right of each one of them to transfer his shares to an outsider.

Kinds of restrictions

In the attempt of stockholders to prevent the corporate shares from falling into the hands of unwelcome persons, various kinds of restrictions on the transferability of shares have been resorted to from time to time. These may be conveniently grouped as follows: (1) absolute prohibition against transfer; (2) those requiring consent of the directors and/or stockholders or a stipulated percentage thereof; (3) those limiting transfers to specified group of persons, or those prohibiting transfer to specified groups; (4) those giving an option to the corporation or its existing stockholders to purchase the shares before they may be sold to third persons; (5) those giving an option to the corporation or stockholders to purchase the shares of a stockholder upon the happening of specified events, like his death or his severance from employment of the corporation; (6) those providing for buy-out arrangements for the transfer of a deceased's shares to the corporation or the surviving shareholders; and (7) those giving the corporation the option to redeem common stock.[6]

In choosing the kind of restriction to be adopted in a given situation, the lawyer must consider foremost the particular needs of the corporation and its stockholders under the circumstances. In many cases, a combination of two or more of the foregoing may be indicated. Tax consequences must be carefully weighed against the advantages gained by the restriction. Most importantly, special care must be taken that the terms, conditions, and form of the restriction are such that the risk of its being held void or unenforceable is eliminated or at least minimized.

This afternoon we shall examine the factors which may affect the validity and practicability of the various stock transfer restrictions to the end that some guidelines may be formulated for a lawyer who is faced with the task of drafting such restrictions.

[6] See O'NEAL, *op. cit.*, pp. 607.

Intrinsic validity of restrictions

In the United States where numerous cases have arisen questioning the validity of various stock transfer restrictions, their judicial treatment has been influenced mainly by the dual character of a share of stock as both contract and property. The earlier cases refused to recognize their validity on the ground that since shares of stock are personal property, their alienation could not be subjected to any restriction. However, a share of stock also represents a contract between the corporation and the shareholder, and the parties should have the freedom to impose therein such terms and conditions as they may deem fit. To reconcile these competing concepts, the rule evolved in common law that the share contract between the corporation and the shareholders may impose restrictions on stock transfers provided that these are reasonable under the circumstances. This judicial attitude gradually found itself expressed in the statutes of several states which now expressly allow stock transfer restrictions.[7]

In this country, the first case involving the issue was *Fleischer v. Botica Nolasco Co.*[8] In this case, a by-law provision required a stockholder who wished to sell his stocks to first offer the same to the corporation, who would have the option to purchase the shares under the same conditions offered by the prospective buyer. Plaintiff had purchased his shares from a stockholder who failed to comply with this requirement. When the corporation refused to register the transfer and to issue a new certificate of stock in his name, plaintiff brought mandamus proceedings, and questioned the validity of the by-laws. The Court citing the earlier American cases, held the by-law void as inconsistent with the Corporation Law under which shares of stock are personal property transferable by mere delivery of the stock certificate indorsed by the owner. Adhering to the theory that shares as property are freely transferable, it held the by-law *ultra vires* because violative and in restraint of the property rights of stockholders. Mandamus was thus granted to compel the officers of the corporation to transfer the shares on the corporate books in the name of the plaintiff-purchaser.

Notwithstanding this decision, the Securities and Exchange Commission has followed the American majority view on the matter and has approved articles of incorporation and by-laws containing restrictions similar to the one in such case, apparently on the

[7] See for example the Illinois Stock Transfer Act; Arkansas Stat. Ann., sec. 64-211; Texas Bus. Corp. Act, art. 2.27; Delaware Gen. Corp. Law, secs. 202 (c) (e), 342 (a) (2); New Jersey Rev. Stat., sec. 14A17-12.

[8] 47 Phil. 583 (1925).

basis of Section 5 of the Corporation Law which allows classification of shares with such rights, voting powers, preferences and *restrictions* as may be provided for in the articles of incorporation.[9] It should be noted in this connection that the restriction in the *Fleischer* case was contained only in the by-laws of the corporation. The Court however did not refer to this nor to Section 5 as a ground for invalidating the restriction.

Admittedly however, even under legislative authority to impose them, restrictions must be reasonable under the circumstances to justify their exception to the fundamental rule of free alienability of property. Thus, an absolute prohibition against the transfer of stock for an unlimited period of time has been unanimously held void as directly contrary to such rule.[10] And our Supreme Court has in one case ordered the cancellation of a stock certificate with the word "non-transferable" written on it, and the issuance in lieu thereof of a new one without such restriction.[11]

There are several factors which may determine the reasonableness of a restriction, and these include the degree of restraint involved, the time limitation, the size of the corporation, its purposes, the method of fixing the transfer price, where the restriction is embodied, and the likelihood of damage to the corporation by hostile stockholders. Courts are much more tolerant of these restrictions in close corporations and when the terms impose only such restraint as may be necessary for the protection of legitimate corporate interests.[12]

It must be kept in mind however that although a restriction may be reasonable and thus valid and enforceable, it cannot operate retroactively and be made to apply to stockholders who were such prior to the restriction, for this would in effect be an impairment of contract obligations.[13]

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[9] It may be argued that validity of restrictions may also be supported by Sec. 13(7) of the Corporation Law empowering corporations to make by-laws for the transferring of its stock. It has been held however, that this kind of provision merely refers to the manner and procedure for transferring stocks, and is not a grant of power to place restrictions on stocks transfers. See Wentworth v. Russell State Bank, 205 P. 2d 972 (1949).

[10] See Allen v. Biltmore Tissue Corp., 161 N.Y.S. 2d 418 (1957) (dictum); Rychwalski v. Baranowski, 236 N.W. 131 (1931); Lawson v. Household Finance Corp., 152 A. 723 (1930).

[11] See Padgett v. Babcock & Templeton, Inc., and Babcock, 59 Phil. 232 (1933).

[12] See Ward v. City Drug Co., Inc., 362 S.W. 2d 27 (1962); Tu-Vu Drive-In Corp. v. Ashkins, 391 P. 2d 828 (1964); *In Re* Mather's Estate, 189 A. 2d 586 (1963).

[13] See Wentworth v. Russell State Bank, *supra*, note 9; People v. Crockett, 9 Cal. 112 (1886); Steamship Dock Co. v. Heron's Adm'x, 52 Pa. St. 280 (1886); *In Re* W.W. Mills Co., 162 Fed. 42; Model Clothing House v. Dickinson et al., 178 N.W. 957 (1920).

Consent restrictions

The kind of restriction which was first widely used in England and the United States was the consent restriction, which requires the consent of the directors or of the other shareholders before any transfer of stocks can be made. Although its validity has been consistently upheld in England,[14] the American courts are divided on the issue. In contrast to the earlier cases which almost unanimously held a consent restriction void as an unreasonable restraint on the free alienability of property,[15] some more recent American cases have under certain circumstances sustained its validity,[16] provided that the approval or disapproval has been reasonably exercised in good faith.[17] The case of *Penthouse Properties Inc. v. 1158 Fifth Ave. Inc.*[18] involved a restriction in the by-laws of a cooperative apartment house requiring the consent of the directors or of two-thirds of the stockholders before any transfer of stock could be made. Only stockholders were entitled to a proprietary lease of an apartment for a term of 99 years. The New York Court, in upholding the validity of the restriction stated:

> In the consideration of this question, the residential nature of the enterprise, the privilege of selecting neighbors and the needs of the community are not to be ignored. The tenant stockholders in a cooperative apartment building are concerned in the purchase of a home. Necessarily therefore, the permanency of the individual occupants as tenant owners is an essential element in the general plan and their financial responsibility an inducement to the corporation in accepting them as stockholders. Under the Plan of Organization, each stockholder is entitled to vote upon the choice of neighbors and their financial responsibility. The latter consideration becomes important when it is remembered that the failure of any tenant to pay his proportion of operating expenses increases the liability of other tenant stockholders. Thus, in a very real sense the tenant stockholders. Thus, in a very real sense the tenant stockholders enter into a relation not unlike a partnership, though expressed in corporate form... The primary interest of every stockholder was in the long-term proprietary lease, alienation of which the corporation had the power to restrain... The stock was incidental to that purpose and

[14] See Grower, *op. cit.*, p. 1377.

[15] See *In re* Klaus, 29 N.W. 582 (1886); McNulta v. Corn Belt Bank, 45 N.E. 954 (1897); Douglas v. Aurora Daily News Co., 11 Ill. App. 506; Morris v. Hussong Dyeing Machine Co., 86 A. 1026 (1913). See also Fleischer v. Botica Nolasco Co., *supra*, where our Supreme Court cites with approval cases supporting this view.

[16] See People ex rel Rudaitis v. Glaskis, 233 Ill. App. 414 (1924); Longyear v. Hardman, 106 N.E. 1012 (1914); Mason v. Mallard Tel. Co., 240 N.W. 671 (1932); Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc., 11 N.Y.S. 2d 417 (1939); 68 Beacon St., Inc. v. Solier, 194 N.E. 303 (1935). Butt see People ex rel Malcolm v. Lake Sand Corp., 251 Ill. App. 499 (1929), *contra.*

[17] See Adams v. Protective Union Co., 96 N.E. 74 (1911); Hughes v. Citizens' Electric Light, Heat & Power Co., 75 Atl. 15 (1909).

[18] 11 N.Y.S. 2d 417 (1939).

> afforded the practical means of combining an ownership interest with a method for sharing proportionately the assessment for maintenance and taxes.

The Court therefore held that the restraint was in every respect reasonable and appropriate to the lawful purposes to be attained.

In another case, the articles of incorporation of a closely held corporation which operated a small telephone exchange provided that no person could become a stockholder unless approved by two directors. The sale to the plaintiff, who was a stockholder in another telephone company operating in the same territory, was not approved by two directors and the company refused to transfer the stock in his name. He filed mandamus proceedings to compel such transfer, questioning the validity of the restriction, but the Iowa Supreme Court denied the petition and held it valid. In determining the reasonableness of the restriction, the court considered only one factor: the fact that the defendant was a small corporation doing a limited business by way of maintaining a local telephone exchange. It recognized the right of stockholders in organizing a corporation to protect themselves against invasion by parties who buy stock mainly for the purpose of "boring from within." At all events, the court concluded, the restriction was a contract obligation between the original stockholders and therefore binding upon them. The Court clearly implied that it would have decided the case the same way even if the sale had not been to a stockholder in a competing corporation.[19]

One advantage of the consent restriction is that it does not tie up the funds of the corporation or of the other stockholders. Considering however that the authorities are split on the question of the validity of consent restrictions and that our Supreme Court in the *Fleischer* case cited, albeit as *obiter*, the earlier American cases with approval, this device for preventing transfer to unwelcome strangers may prove unreliable.

Restrictions limiting transfers to certain classes of persons

Provisions which allow transfers only to specified classes of persons, like existing stockholders and their families, have rarely been involved in court litigation, but have met mostly with judicial disapproval. In *Wentworth v. Russell State Bank*,[20] the by-laws of the defendant bank provided that no certificate of stock shall be issued to surviving heirs of a deceased stockholder unless such heirs resided within fifty miles of the city where the bank was located, or

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[19] Mason v. Mallard Telephone Co., 240 N.W. 671 (1932).
[20] 205 P. 2d 972 (1949).

have been bank customers for one year. The Kansas Supreme Court held such by-law void because it was not authorized by the provisions of the general corporation code of the state, and was an unreasonable restraint on the right to sell property.[21]

This type of restriction in effect gives only partial control over the choice of future stockholders and may not accomplish the purpose of warding off undesirable associates. Aside from the difficulty which may be encountered in defining the class of allowable transferees, new members of the class may not meet the standards which the stockholders had in mind — like trustworthiness or capability in participating significantly in corporate affairs.

First option restrictions

By far the most popular provision restricting stock transfers in close corporations is one which requires a stockholder who wishes to sell or transfer his stock to first offer the same to the corporation or to the other stockholders and give the latter an opportunity to acquire the same should they wish to do so. The option may be in favor of the corporation, or of the other stockholders, or of the corporation and the stockholders, successively.

The earlier American decisions held even this kind of restriction void as a restraint on the alienability of property.[22] As stated earlier, a similar restriction was held void by the Philippine Supreme Court in the *Fleischer* case decided in 1925.[23] At present however, the great weight of American authority is in favor of its validity, if the restriction is reasonable in its terms and justified under the circumstances. And in some cases, the court merely assumes its reasonableness, without much analysis of its terms.[24]

The leading case on this matter is *Barrett v. King et al.*[25] where the stock certificate stated that it was transferable only in accordance with the by-laws of the company printed on it. One of these by-laws contained a thirty-day option restriction on stock transfer. Plaintiff bought his shares from a stockholder who did not comply with the provision. In upholding the validity of the

[21] See also McNulta v. Corn Belt Bank, 45 N.E. 954 (1897); Sargen v. Franklin Ins. Co., 19 Am. Dec. 306 (1829); Kaetzer v. Lightning Rod Co., 181 S.W. 1066 (1916), where the Mo. Court held in what is believed as a weak decision that a by-law prohibiting sale to a person interested in a competing business is void.

[22] See Victor J. Bloade Co. v. Bloade, 34 A. 1127 (1896); Brinkerhoff-Farris Trust & Savings Co. v. Home Lumber Co., 24 S.W. 129 (1893); Ireland v. Globe Milling Co., 41 A. 258 (1898).

[23] See note 8, *supra*.

[24] See for example Evans v. Dennis, 46 S.E. 2d (1948).

[25] 63 N.E. 934 (1902).

restriction, the Massachusetts Supreme Court, speaking through Justice Holmes, made the following oft-cited observation:

> As to public policy, we see nothing in the provision contrary to that, at least as between the plaintiff and the corporation.... Furthermore, looking at the stock merely as property, it might be said that as far as appears and probably in fact, it was called into existence with this restriction inherent in it, by the consent of all concerned.... Stock in a corporation is not merely property. It also creates a personal relation analogous otherwise than technically to a partnership.... there seems to be no greater objection to restraining the right of choosing ones associates in a corporation than in a firm.

In *Lawson v. Household Finance Co.*,[26] the court considered the option reasonable because it was necessary to the attainment of the objects set forth in the charter, and the success of the company would be in danger without the corporations right to purchase the stock. The business of the corporation in this case was to loan small amounts of money largely upon the reputation of the borrower without any collateral security. The business required the employment of competent and honest persons who could be depended upon to protect the company's interests. Such persons could best be secured by providing them with an interest in the business and in order to be able to do this, the company had to have the privilege of purchasing its own stock in preference to others. The Court observed that the restrictions were not absolute and did not prevent the ultimate alienation of the stock, but simply regulated the transfer by giving the board of directors an option on the stock for a specified time.

Answering the contention that by making such restrictions the company was attempting to obtain for the corporation the advantages of a partnership, the Court stated that there can be no legal objection to this provided they do not infringe the laws which govern corporations.

The option restriction has also been attacked as violative of the rule against perpetuities where there is no specified time limit for its effectivity. The prevailing view however is that it does not violate such rule, the purpose of which was to prevent the tying up of land and its removal from commerce for long periods of time by the creation of future estates which would prevent the alienation of lands.[27] The option restriction however creates no interest whatsoever in the stocks, nor does it convey title thereto, nor create

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[26] 152 Atl. 723 (1930).

[27] See Everett Trust & Savings Bk. v. Pacific Waxed Paper Co., 157 P. 2d 707 (1945); Warner & Swasey Co. v. Rusterholz, 41 F. Supp. 498 (1941).

rights in the optionee except rights *in personam*, and therefore not violative of such rule.[28]

Although the option restriction usually refers only to voting stocks, the circumstances may be such as to justify its applicability to non-voting stocks. Thus, where the purpose of the restriction was to allow the corporation to acquire its non-voting stocks so that it could transfer the same to its employees, its validity was upheld.[29] Limited restrictions are upheld primarily because they are for the benefit of the corporation, promote good management, and enable it to attain its legitimate objectives. The restriction in question would give the corporation's employees an opportunity to own stock, which ownership would tend to increase the interest of the employees in and their loyalty to the corporation.[30] The restriction as to non-voting stocks was therefore held reasonable under the circumstances.

The size of the corporation has always been one of the most important factors in determining the reasonableness of an option restriction running in favor of stockholders. In most of the cases where the agreement has been upheld, the corporation involved was closely held. In some statutes which expressly allow restrictions, a specified number of stockholders is laid down as reasonable. In Texas for example, the statute provides that the restriction would be reasonable if there are not more than twenty holders of record of the same class.[31] In one case involving this statute, the articles of incorporation gave a Texas corporation an option to buy a selling stockholder's shares for a period of thirty days, and if the corporation did not exercise the option, then the holder was required to notify all the other shareholders of the same class, giving them another ten-day option to buy on a *pro rata* basis. Only after this would he be free to sell any remaining shares not bought under the option. The corporation had more than twenty shareholders. In holding the restriction void, the Texas Court of Civil Appeals explained the rationale behind the statutory provision thus: "The wisdom of the statute is apparent, because of restrictions on transferring shares are permitted by corporations such as those we have here, in situations where there are a great many stockholders, then it becomes too onerous and cumbersome a burden on the stockholder who wishes to transfer his stock, and thereby becomes an unreasonable restraint on the alienation of his stock."[32]

[28] *Ibid.*
[29] McDonald v. Farley & Loetscher Mfg. Co., 283 N.W. 261 (1939).
[30] *Ibid.*
[31] Texas Business Corp. Act, Art. 2.22, subsec. B(2).
[32] Ling & Co. v. Trinity Savings & Loan Assn., 470 S.W. 441 (1971).

The length of time during which the option may be exercised is decidedly an important factor in determining the reasonableness of an option restriction. Although there is hardly any case in which the length of period allowable has actually been tested before the American courts, there are many decisions which have enforced options for periods ranging from twenty to sixty days.[33] In a few cases, a ninety-day option was enforced,[34] and in one case, even a six-month period was sustained.[35] On the other hand, a period as short as five days has been impliedly approved.[36] Obviously, the period should be long enough to afford the optionees a reasonable time to determine whether they can raise the necessary funds, and short enough so that there will be no substantial change in the corporation's prospects between the time of the option offer and the acceptance or rejection thereof. The present policy of the Securities and Exchange Commission is to limit the option period to one month, a period which it deems sufficient for the corporation or stockholders to decide whether or not they will take the offer.[37]

In this connection, it is to be observed that in the case of *Fleischer v. Botica Nolasco Co.*,[38] the by-law providing for the option restriction did not contain any time limit within which the corporation could exercise its option to buy. The Supreme Court never referred to this as a ground for holding the stipulation void. It is submitted that even if the Court had followed the prevailing view upholding reasonable restrictions, the particular provision in this case could have been struck down as unreasonable because it provided no time limit within which the corporation should act before allowing the free transfer of the shares.

Even where an option restriction may be valid because justified and reasonable under the circumstances, its terms, when ambiguous or not specific, are usually construed in favor of free transferability. Thus, where the restriction gives the option to the other shareholders, it has been interpreted to exclude a sale by one stockholder to another stockholder. According to the prevailing view, these restrictive pro-

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[33] See Barret v. King, 63 N.E. 934 (1932), 30 days; Diebel v. Kaufman, 62 N.E. 2d 770 (1945), 30 days; Kentucky Package Store v. Checani, 117 N.E. 2d 139 (1954), 20 days; Lawson v. Household Finance Corp., 152 A. 723 (1930), 20 days; Monotype Composition Co. Inc. v. Kiernan, 66 N.E. 2d 565 (1946), 30 days; Model Clothing House et al v. Dickinson, 178 N.W. 957 (1920), 60 days.

[34] See Allen v. Biltmore Tissue Corp., 161 N.Y.S. 2d 418 (1957); Aremteen v. Sherman Towel Serv. Corp., 185 N.E. 822 (1933); Menke v. Gold Medal Oil Co., 191 N.E. 472 (1933); Chaffee v. Farmers Coop. Elevator Co., 168 N.W. 616 (1918).

[35] Weiland v. Hogan, 143 N.W. 399 (1913).

[36] See Wentworth v. Russell State Bank, 205 P. 2d 972 (1949); Stern v. Stern, 146 F. 2d 870 (1944).

[37] See SEC Opinion dated Oct. 13, 1964, SEC Folio, p. 217.

[38] *Supra*, note 8.

visions are ordinarily employed to keep the association intact and to prevent transfer of stock to outsiders who might enter the corporation to gain information concerning it for their own selfish ends and to use it against the best interests of the corporation. In the absence of clear and specific language which compels an interpretation that notice is required to other stockholders in case of a sale by one stockholder to another stockholder, such provision, according to this view, should be taken to mean only that the stockholders are to be given an opportunity to purchase the stock before it is offered to non-stockholders.[39] This view has been criticized as short-sighted, since it enables two or more stockholders, by connivance or otherwise, to nullify contractual provisions entered into and agreed upon by the incorporators for their mutual benefit. One of the purposes of the provision is to prevent private agreements between stockholders to get control of the company, a purpose which may be thwarted by the interpretation of the majority view.[40]

Similarly, a restriction which provides that no stockholder can transfer his voting shares to anyone without giving other holders of voting stock an opportunity to acquire the same in proportion to their respective stockholdings, has been held not to apply to a voting trust agreement. The restriction agreement is calculated to retain control of the corporation in the stockholders who were parties thereto. The voting trust agreement is merely the form in which certain stockholders, retaining beneficial ownership, saw fit to assert that measure of control which was represented by their stockholdings. And although the voting trust agreement affects the proportionate voting control among the stockholders, where the language of the restrictive provision does not clearly include a voting trust agreement, stockholders may transfer their shares to a voting trustee without complying with the requirement of notice to the other shareholders.[41] Again here, it would seem that the purpose of the option restriction is partly thwarted by the court's interpretation. For why would said agreement stipulate that the stocks acquired under the option should be distributed in proportion to the stockholders' holdings, if the purpose were not also to prevent any transfer or scheme which would affect the balance of control in the corporation?

Neither does the option restriction apply to a sale of all the corporate assets. And should the by-law providing for the option expressly cover a sale of corporate assets, it should not be incon-

[39] Talbot v. Nibert, 206 P. 2d 131 (1949); Rychwalski v. Milwaukee Candy Co., 236 N.W. 131 (1931); Serota v. Serota, 5 N.Y.S. 2d 68 (1938).
[40] See diss. op., Talbot v. Nibert, *supra*.
[41] Gamson v. Robinson, 135 N.Y.S. 2d 505 (1954).

sistent with the provisions of law pertaining to such sales.[42] By-laws cannot be inconsistent with or in contravention of existing law,[43] and if the procedure for the option restriction is different from the provisions of the law on sale of corporate assets, such an option contract cannot be enforced.[44]

Unless specifically so provided, the option restriction applies only to voluntary sales and not to judicial sales or transfers by operation of law.[45] However, in one case,[46] it was held applicable to a pledge of shares where the stockholder indorsed his stock certificate in blank and delivered it to the pledgee. The Court observed that any other rule would allow the restriction to be circumvented by the simple device of a pledge and a subsequent sale by the pledgee, or by a transfer that might enable a pledgee to obtain a new certificate in his own name upon which he might vote. The transaction, if not a sale, is a transfer covered by the restriction on any "sale or transfer."[47] The pledge was just as repugnant to the restriction agreement as a transfer intended to be absolute and final would have been. It presented almost as great a threat of interference by strangers in the corporate affairs.[48]

Even where the option restriction refers to "sale or transfer", it does not cover a disposition by will. The option agreement means merely that the stockholder must make the offer to the corporation or to the other stockholders before he voluntarily transfers his stock, not that he will make the offer before he dies. It does not therefore prevent a transmission or devolution of his shares upon his death.[49]

The option restriction may however expressly provide that upon the death of a stockholder, the corporation or the other stockholders shall have the option to purchase his shares within a specified period. Most courts uphold the validity of this kind of restriction. In *Scruggs v. Cutterhill et al*,[50] all the four stockholders of the corporation entered into such an agreement. It was alleged that it could not be enforced as it was in the nature of a wager upon life and

[42] See Sec. 28 1/2 Corporation Law for requirements of sale of all corporate assets.

[43] Corporation Law, sec. 13(7).

[44] Dorby v. Dorby, 262 P. 2d 691 (1953). See also Weber et al v. Lane et al, 24 N.W. 2d 418 (1946).

[45] McDonald v. Farley & Loetscher Mfg. Co., 283 M.W. 261 (1939); *In re* Trilling v. Montague, 140 F. Supp. 260 (1956); Barrows v. Natl. Rubber Co., 12 R. I. 173 (1878).

[46] Monotype Composition Co., Inc. v. Kiernan, 66 N.E. 2d 565 (1946).

[47] *Ibid.* But see Crescent City Seltzer & Mineral Water Mfg. Co. v. Deblient, 3 So. 726 (1878), *contra.*

[48] *Ibid.*

[49] Stern v. Stern, 146 F. 2d 870 (1944).

[50] 73 N.Y.S. 882 (1902).

interfered with the devolution of property under a will. The New York Court however brushed aside these contentions stating:

> These parties during their lifetime evidently regarded their business as prosperous, and that it could be made to so continue if the persons then engaged in its management could continue in its control and carry out its policy, and to this end they made a contract which, among themselves at least, they deemed advantageous for the business, and, having the contingency of death ever present, stipulated in respect to it. We know of no principle of law which prohibits such a stipulation or upon which it may be held invalid. In every case of the devolution of property by will, it is subject to the just obligations of the testator, which are required to be fulfilled and discharged before the property passes to the legatee.... And an agreement which seeks to cotnrol the stock of a corporation for purposes of management, lawful in itself, is not subject to any infirmity, but is the exercise of a legal right.

Since all the elements of a good contract were present, and the plaintiff had complied with the terms thereof, the court held the restriction enforceable.[51]

The case of *Oakland Scavenger Co. v. Gandi*[52] presented an even more restrictive agreement. The business of the corporation was completely dependent on the personal services of its stockholders, all of whom had agreed to transfer their stock to the corporation in trust to be transferred upon the death of the stockholder to his son or some other person qualified to fill the vacancy. Considering the personal nature of the corporate business, the California Supreme Court was of the opinion that the agreement was not opposed to public policy, and that it was valid because its object was to give the corporation some control of its stockholder personnel.

Instead of applying the restriction to a transfer or sale by the stockholder, the option to the corporation may be made to depend on the occurence of other specified events. We have already seen that options available upon the death of a stockholder have met with judicial approval. Options given to the corporation upon the termination of a shareholder's employment are quite common. Although some courts have looked at these with disfavor,[53] others have upheld them as valid,[54] even if employment can be terminated at

[51] *Ibid.* See also Warner & Swasey Co. v. Rusterholz, *supra;* Ionic Shop, Inc. v. Rothfeld, 64 N.Y.S. 2d 101 (1946); Empire Trust Co. v. Kurrus, 235 N.Y.S. 410 (1929); Kentucky Package Store v. Checani, 117 N.E. 2d 139 (1954); Oakland Scavenger Co. v. Gandi, 124 P. 2d 143 (1942); Greater New York Carpet House Inc. v. Herschmann, 17 N.Y.S. 2d 483 (1940).

[52] 124 P. 2d 143 (1942).

[53] Lufkin Rule Co. v. Sec. of State, 127 N.W. 784 (1910).

[54] See, Armteen v. Sherman Towel Service Corp., 185 N.E. 822; Harker v. Ralston Purina Co., 45 F. 2d 929 (1930).

will by the corporation.[55] This kind of option restriction fulfills a legitimate business need, specially where the corporation in order to insure efficiency and loyalty, has a plan for employee share-ownership. And as long as the option to purchase is exercised by the corporation in good faith, and not for the purposes of reprisal, spite or other motives tending to show bad faith, the agreement has been enforced.[56]

While the period during which the option may be exercised has not yet lapsed, the stockholder has no right to sell his shares. In *Diebel v. Kaufman*,[57] the by-laws contained a provision that a stockholder desiring to sell must first offer the stock to the company which would have the option to purchase within thirty days if the stockholders voted to do so. The defendant made the offer to the corporation on May 18, and although the board of directors approved it in a meeting held on June 4. Thereafter, the defendant announced that he was accepting bids up to June 7, and that on that day, he would sell it to the highest bidder. Plaintiff was the highest bidder, and when defendant refused to accept his bid because he had just been served with pleadings filed in court involving the stocks, plaintiff filed a suit for specific performance. The Court refused to grant it stating that until the 30-day option period agreed upon had not elapsed, the stockholder could not legally sell it to a third person, for although the stockholders at one meeting might refuse to accept the offer, they might well reconsider their action within the thirty-day period and decide to purchase the stock. Unless the corporation had notified the defendant of its rejection within said period, the defendant was not at liberty to sell it before the period lapsed.

A final word as to option restrictions—it would perhaps be best that the option be in favor of the corporation and the stockholders successively, so that if the corporation has no surplus funds, the stockholders may, if they wish to and have the necessary funds, take the offer, and vice versa. An option in favor of the corporation only, though valid, cannot be enforced if the corporation has no surplus profits out of which it can pay the transfer price.[58] The purpose of

[55] *Ibid.*

[56] Lewis v. H. P. Hood & Sons Inc., 121 N.E. 2d 850 (1954). In Systematics Inc. v. Mitchell, 253 Ark. 848, 491 S.W. 2d 40 (1943), the requirement imposed on the employee to give a first offer to the corporation upon termination of his employment was held unreasonable on another ground—that the price was not fair. The Court assumed that such an option would otherwise be valid.

[57] 62 N.E. 2d 770 (1945).

[58] See last paragraph of Sec. 16, Corporation Law. See also Steinberg v. Velasco, 52 Phil. 953 (1929); Steinbugler v. Williams C. Atwater & Co., Inc., 47 N.E. 2d 432 (1943).

the restriction may thus be defeated by the inability of the corporation to take the offer, although the stockholders would have been able to furnish the necessary funds.

Buy-out agreements

In a close corporation, the active participation of each stockholder is oftentimes of vital importance to the financial welfare of all. His death would therefore adversely affect the corporate business. Moreover, the corporation's smooth and efficient operations may be severely threatened by the possibility of the stock falling into the hands of heirs who may have little interest in, or even hostility to, the corporation and its management. This eventuality can be provided against by the use of a buy-out agreement. This arrangement is one under which a shareholder's stocks will be bought by the corporation or the remaining shareholders upon his death. It may either be optional or mandatory. Since one of its basic goals is to prevent the disposition of the decedent's stock to outsiders, to be completely effective, it should be coupled or used with the corporation's or shareholders' option to purchase when a stockholder during his lifetime wants to sell or transfer his stock. A buy-out arrangement can also prevent a deadlock, or harassment by those who inherit stock from the decedent. His heirs and the surviving shareholders may have conflicting goals for the corporation which may complicate the management thereof. Questions like whether earnings should be distributed as dividends or reinvested in the business, and whether the business should undertake new ventures are some areas of potential conflict which a buy-out arrangement can eliminate.[59] From the viewpoint of the corporation, a buy-out agreement which obligates the decedent's estate to sell if the corporation or remaining stockholders decide to buy is the most advantageous arrangement.

If the agreement is mandatory on the corporation or its stockholders, it may also prove beneficial to the estate of the deceased stockholders. His interest in the corporation can be easily liquified where the estate's assets are not sufficient to pay the decedent's debts as well as estate and inheritance taxes. The proceeds from the sale of his stock to the corporation may well solve the problem.

Where the purchaser is the corporation, a buy-out arrangement is referred to as an *entity-purchase*. It is a *cross-purchase*, where the purchasers are the remaining shareholders. In choosing one or the other, several factors must be considered. In the entity-purchase, for example, the question of funding the purchase is of utmost im-

[59] Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 8 (1969).

portance. Under the present state of the law, a corporation cannot purchase its own stocks unless it is from surplus earnings.[60] Thus, where the purchaser under a mandatory buy-out agreement will be the corporation, the funding of such purchase should be provided for ahead of time, otherwise, if the corporation has no surplus at the time of the stockholder's death, then the buy-out agreement would be useless as a method of warding off unwelcome outsiders. One way to raise the funds would be to constitute a reserve fund set aside each year from corporate earnings. The disadvantage here is that the stockholder may not live long enough for the corporation to accumulate the necessary reserve to buy his stock.

A more popular way of funding the corporation's purchase is the taking of life insurance policies on the lives of the shareholders. If the proceeds are made payable to the corporation upon the death of the stockholder, then said proceeds may be used to buy out the deceased's shares. This may however raise the question of the corporation's insurable interest in the life of its stockholders. If all the stockholders participate actively in its management then there may be sufficient legal basis to support the corporation's insurable interest. Other problems may arise. The cost of insurance may become prohibitive where one or more stockholders are high insurance risks. Moreover, if at the time of the stockholder's death the corporation has more liabilities than assets, then the use of the insurance proceeds to purchase his stocks may not be legally feasible.[61]

The cross-purchase plan allows the surviving shareholders to purchase the deceased's shares in proportion to their shareholdings. Aside from limiting the class of potential shareholders, this plan can prevent a shifting of control in a close corporation. If brothers Juan and Pedro Cruz each own 30% of the shares, and brothers Tony and Jose Reyes each own 20% of the shares, Juan's death can possibly divest his brother Jose of control unless there is a cross-purchase buy-out arrangement. As in the entity-purchase plan, funding the purchase is a problem to be met. The surviving shareholders must have sufficient funds to acquire the shares. Here again, life insurance policies may give the answer. This would mean that each stockholder would have to take out a policy on the life of each of the other stockholders with himself as beneficiary, in an amount that would pay that stockholder's proportionate part of any one of the

60 See Corporation Law, sec. 16.

61 See Greater New York Carpet House Inc. v. Herschmann, 17 N.Y.S. 2d 483 (1940), where the court stated that the buy-out agreement cannot be enforced if the defendant shows impossibility of performance, due to the fact that the rights of the corporation's creditors may be impaired by the purchase.

other stockholders' interests. It may prove very expensive where there are more than four or five other stockholders. Whether the value to be gained by warding off undesirable associates would be commensurate with the cost of the life policies will of course depend on the particular circumstances of each case.

Unlike in the case of the corporation's sometimes doubtful interest in the life of each stockholder, there is little doubt that a stockholder in a close corporation has an insurable interest in the lives of his fellow stockholders because the death of one of them will probably cause a loss to the survivors through the introduction of strangers into the corporate management.

The intrinsic legality of buy-out arrangements, specially of the optional type, has been recognized in many cases and is clearly well-settled in American jurisprudence.[62] Since buy-out arrangements are not consummated until the seller's death, the question of whether it is a testamentary disposition has also often been raised. Most courts have held that these are not testamentary in nature and would therefore be valid though they do not comply with the formalities of a will.[63]

Callable common stock

A manner of restriction found useful by some close corporations is one which gives the corporation the power to redeem or call common stock. Although provisions of this nature have been generally recognized as valid as to preferred stock, some doubts have been raised in the case of redeemable common stock.[64] The main objection to this kind of a restriction is that it "borders close upon a restraint against transferring property to any one in the whole world except to the corporation, for such must be the effect as a practical matter of the obligation of the holder at any time to sell to the corporation upon its demand. The restraint upon the free right of sale and transfer is made quite evident when it is considered that when the stockholder is free to sell to others than the corporation, any possible pur-

[62] See Warner & Swasey Co. v. Rusterholz, 41 Fed. Supp. 498 (1941); Scruggs v. Cotterhill, 73 N.Y.S. 882 (1902); Krebs v. McDonald's Ex'x, 266 S.W. 2d 87 (1953); Oakland Scavenger Co. v. Gandi, 124 P. 2d 143 (1942); Bohnsack v. Detroit Trust Co., 290 N.W. 367 (1940); Fitzimmous v. Lindsay, 54 A. 488 (1903); Coe v. Winchester, 33 P. 2d 286 (1934); Greater New York Carpet House v. Herschmann, *supra.*

[63] See Thompson v. J. D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917); Chase Nat'l Bank v. Manuf. Trust Co., 265 App. Div. 406, 39 N.Y.S. 2d 370 (1943); Johnson v. Johnson, 87 Colo. 207, 286 P. 109 (1930).

[64] Sec. 5 of the Corporation Law which allows the articles of incorporation to issue different classes of shares with such rights, preferences and *restrictions* as may be specified therein seems to sustain the view that common stock may be made subject to redemption by corporation.

chaser who might be disposed to buy the stock would immediately observe its liability to be bought in by the corporation at any time in the indefinite future in the exercise of its own uncontrolled discretion."[65] Thus, it not only places the stockholder at the mercy of the directors, but it makes it difficult for him to dispose of his stock.[66]

The utility of the corporate redemption privilege in a closely held corporation is aptly illustrated by the case of *Lewis v. H. P. Hood & Sons Inc. et al.*[67] Plaintiff had just retired as director and officer of the defendant, an employee-owned and controlled corporation. Pursuant to a provision in the articles of incorporation, the corporation notified him of its desire to redeem his stock. Although it was the unbroken custom for retiring stockholders to sell their shares to the corporation, plaintiff refused to abide by it. Since he had no intention to sell his shares to anyone else, the corporation's right of a first option to purchase upon transfer was useless. Without the redemption provision, the corporation could not have prevented him from participating in future corporate profits which only he among the shareholders had not helped earn. It was obviously the purpose of the provision to prevent this situation and to protect the other employee-shareholders who had relied on the profit-sharing nature of the corporation when they bought their shares. Considering these circumstances, the Massachusetts Supreme Court upheld the validity of the redemption provision and granted specific performance, stating:

> Nor do we think the inherent nature of common stock is such as to be incompatible with a call provision of the sort under consideration. A stockholder is free to purchase or not as he pleases. He buys with an eye to investment and profit. But if he acquires stock on terms whereby his investment may be temporary and his profits short-lived, he has assented in advance to such terms and we see no reason why he may not do so. He gets what he bargained for and if the call provision is exercised he is in no position to complain.[68]

As to the argument that stock subject to such a redemption or call provision would be difficult to dispose of, the Court observed that the same could be said of other provisions restricting the transfer of stock, the validity of which has been upheld. As to the allegation that the call provision violated the basic doctrine that all holders of the same class of shares be treated alike, the Court noted that even a valid provision cannot be exercised oppressively or for the purpose of discriminating against a single stockholder or group of stockholders. But where the evidence as here, showed that the call had been

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[65] Greene v. E. H. Rollins & Sons Inc., 2 A. 2d 249 (1938).
[66] *Ibid.*
[67] 121 N.E. 2d 850 (1954).
[68] *Ibid.* See also Longyear v. Hardman, 106 N.E. 1012 (1914).

exercised not for motives showing bad faith but fairly and in good faith, there was no reason to deny relief.[69]

Transfer Price

One of the more troublesome questions involved in option restrictions as well as in buy-out agreements is the price which the corporation or the other stockholders should pay for the stocks. In most cases, the agreement itself either fixes a price or at least provides for a method of arriving at the value of the stock. Without a stipulation as to the transfer price, the possibility of the parties reaching an impasse will be very great, and expensive litigation may ensue. On the other hand, the price must be sufficiently attractive so as not to discourage desirable investors in putting their money in close corporations where their interest cannot be as easily liquified as in others. Fixing a price is thus a difficult task for the draftsman. He must try to strike a balance between the desire of the corporation to attract the proper investors and the interest of the future purchaser, whether it be the corporation or other shareholders, in not paying more than a fair price.

The most common price agreed upon is the book value of the shares. This however may often prove unreliable in gauging the actual worth of a going concern, since fixed assets are usually not carried on the corporate books at their true value, and intangibles like goodwill are rarely accurately reflected therein. It is therefore a potential source of disputes, and even the courts are not in full agreement as to how its determination should be made.[70]

On the other hand, reference to market value would in most cases be impractical and difficult of implementation. Stocks in a close corporation would rarely have a market outside the corporation.

Sometimes, the parties fix a definite figure, usually the par value, at which the optionee may purchase. Many of the decisions have supported the enforceability of the price so fixed as part of a binding contract. In *Allen v. Biltmore Tissue Corp.*,[71] the restriction agreement fixed the price as that which the company received from the stockholder originally. The stockholder had paid the corporation $5 per share for the shares which he acquired soon after incorporation, and $10 per share for these he acquired four years later. Although

[69] *Ibid.*

[70] See Corbett v. McClintic-Marshall Corp., 151 Atl. 218 (1930); Aaron v. Gillman, 307 N.Y. 157, 128 N.E. 2d (1955); Lassallette v. Parisian Baking Co., 242 P. 671 (1952); Palmer v. Chamberlin, 191 F. 2d 674 (1951); First Nat'l Bank v. Coldwell, 145 N.Y.S. 2d 674 (1955).

[71] 141 N.E. 2d 812, 161 N.Y.S. 2d 418 (1957).

the corporation offered to pay $20 per share, the offer was refused on the ground that the price specified in the by-law was unreasonable and unfair, thus rendering the whole premium void. The New York Court upheld the by-law and held that the stockholder was bound by his contract, stating:

> Carried to its logical conclusion, such a rationale would permit, indeed, would encourage, expensive litigation in every case where the price specified in the restriction, or the formula for fixing the price, was other than a recognized and easily ascertainable fair market value. This would destroy part of the social utility of the first option type of restriction which, when imposed, is intended to operate in *futuro* and must therefore include some formula for future determination of option price.... Obviously, the case where there is an easily ascertainable market value for the shares of a closely held corporate enterprise is the exception, not the rule, and, consequently, various methods or formulae of fixing the option price are employed in practice.... In sum then, the validity of the restriction on transfer does not rest on any abstract notion of intrinsic fairness of price. To be invalid, more than mere disparity between option price and current value of the stock must be shown.... Since the parties have in effect agreed on a price formula which suited them, and provision is made freeing the stock for outside sale should the corporation not make, or provide for, the purchase, the restriction is reasonable and valid.[72]

Similarly, in another case, the Nebraska Supreme Court enforced the contract price fixed at par value or one less, although there was an outside offer to buy at more than three times the par.[73]

A definite peso figure may be satisfactory for a short period, but after the corporation has been in business for some time, the actual value of the shares may be much more than par. In such a case, court litigation becomes a strong probability. This problem may be solved by providing that the parties meet periodically to revalue the shares, the last value agreed upon to be the transfer price for any subsequent purchase. This method has been held to be binding as part of a valid contract between the parties. It does not matter that there has been an increase in actual value since the last valuation, as long as it was made in good faith.[74] The disadvantage of this method is that the parties may not be able to agree on the price when revaluation time comes, increasing again the possibility of court litigation.

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[72] *Ibid.*

[73] Elson v. Schmidt, 1 N.W. 2d 314 (1941). See also Sterling Loan & Investment Co. v. Litel, 223 P. 753 (1924); Fopiano v. Italian Catholic Cemetery Assn., 156 N.E. 708 (1927); Nicholson v. Franklin Brewing Co., 91 N.E. 991 (1910). But see Systematics Inc. v. Mitchell, 491 S.W. 2d 40 (1973), where the Court did not follow the contract price but what it found to be the fair market value, mainly because of an Arkansas statute which required "fair price".

[74] See Krebs v. McDonald's Ex'x et al., 266 S.W. 2d 87 (1953).

One of the more common agreements as to how to fix the transfer price is the appraisal method. The most typical provision is one where each party chooses one appraiser, the two thus chosen to select a third one. An ideal agreement would not only provide for a method of choosing the appraisers, but would include standards to guide their decision and a stipulation that the decision of the majority of them shall be binding. It should also set a time limit within which the appraisers are to arrive at a determination of the appraised value.[75] Furthermore, it would be wise and practical to allow the parties to waive the appraisal requirements and instead mutually agree upon the value of the shares. The appraisal method can become expensive and the parties may decide to dispense with it.

It is sometimes agreed that the appraisal shall be made by the directors. The objection to allowing interested parties to fix the price is obvious. But since the appraising directors act as fiduciaries, their duties as such are enforceable by the court.[76] However, it has been held that their decision cannot be impeached for mere errors of judgment, and as long as the directors act in good faith, specific performance will be granted although the appraised value arrived at is inadequate or low. The difference must be so great as to lead to a reasonable conclusion of fraud, or concealment in the nature of fraud, and to render it plainly inequitable and against conscience that the contract should be enforced.[77]

A reasonably satisfactory method of fixing the transfer price would be a combination of the last two methods—a price fixed at a definite figure to be revised periodically by the stockholders, and, in case of disagreement in the periodical revaluation, the use of the appraisal method, with the price last agreed upon as the basis for the appraisers' calculations. This will be relatively simple to draft and will minimize disputes and thus expedite transfers.[78]

Formal validity of restrictions

We have seen that the intrinsic validity of a stock transfer restriction depends on the reasonableness of its terms, taking into consideration the particular circumstances of each case. Assuming that it is otherwise valid, the form in which it is made may also affect its binding force. Section 5 of the Corporation Law provides, in part:

[75] See Lawson v. Household Finance Corp., 152 A. 723 (1923), for a well-drafted appraisal provision.

[76] Anderson v. Bean, 172 N.E. 647 (1930).

[77] New England Trust Co. v. Abbot, 38 N.E. 432 (1894). See also Krebs v. McDonald's Ex'x et al., *supra*. But see Ling & Co. v. Trinity Savings & Loan Assn., 470 S.W. 441 (1971), for obiter to the contrary.

[78] See O'NEAL, *op. cit.*

> The shares of any corporation formed under this Act may be divided into classes with such rights, voting powers, preferences, and restrictions as may be provided for in the articles of incorporation....

If it is included in the articles of incorporation, the restriction, if intrinsically valid, will be treated as inherent in the share itself and consequently binding among the original stockholders and their heirs, as well as on subsequent subscribers to the corporate stock.[79] However, in order to affect those who purchase stocks from the shareholders, the restriction must furthermore appear on the stock certificate.[80] Should the restriction appear in the articles of incorporation but not on the certificate of stock, it will bind all stockholders and third parties with notice of such restriction,[81] but cannot prejudice the rights of innocent purchasers from the shareholders. Although it has been held that a restriction is sufficiently stated on the certificate by a legend noting that the stock is issued "subject to restriction" and specifying in what sections of the articles of incorporation it may be found,[82] whenever possible, the restrictive provision should be set forth *verbatim* on the stock certificate in order to avoid the risk of its not being applied against an innocent purchaser of the stocks. It is true that the articles of incorporation would be binding on the stockholders as a contract and any stockholder who transfers his stock contrary to an intrinsically valid restriction may be held liable for damages for breach of such contract. Yet, since the sale to the innocent purchaser cannot be cancelled, the right to damages will obviously not serve the purpose of the restriction, and would thus not be an adequate remedy. Unwelcome outsiders who are ignorant of the restriction could still succeed in entering the corporation. Only specific performance of the restriction agreement can effectively carry out its purpose—thus the imperative necessity of warning third persons thereof by stating the restriction on the stock certificate as clearly as possible.

If the restriction is made merely a part of an agreement among all the stockholders without being included in the articles of incorporation, would the restriction be void for all purposes? Section 5 of the Corporation Law just quoted does not clearly say so. It is

[79] See Gilbs v. Long Island Bank, 31 N.Y.S. 406 (1894). See also SEC Opinion dated Nov. 10, 1976, SEC Folio, 1974.

[80] This is the SEC policy. See SEC Opinion dated Oct. 13, 1964, SEC Folio, 1977 ed., p. 217-218. See also Fleischer v. Botica Nolasco Co., *supra*.

[81] SEC opinion dated Sept. 9, 1975, SEC Folio, *op. cit.*, p. 830-831. See also Tomoser v. Kamphausen et al., 121 N.E. 2d 622 (1954); Cross v. Beguelin, 169 N.E. 378 (1929); Doss v. Uingling, 172 N.E. 801 (1930); Bauhmol v. Goldstein, 124 Atl. 118 (1924). See Ling & Co. v. Trinity Savings & Loan Assn., 470 S.W. 441 (1971), where the stock certificate carried the restriction but in small print. The Texas court held it void statute which required that there be conspicuous notice on the certificate.

[82] See Allen v. Biltmore Tissue Corp., *supra*.

submitted that taken as a mere private contract of the stockholders, it should be binding among them as such, although it cannot affect anybody else, whether he be a subsequent subscriber to the corporate stock, or one who without knowledge of the agreement purchases stocks from any of the stockholders parties to such contract.

Likewise, where the restriction appears only in the by-laws and not in the articles of incorporation as required by law, it may still be given effect as a binding contract among the shareholders who assented to it.[83] However, they will not bind third parties or subsequent stockholders without notice.

Although the restriction may already appear in the articles of incorporation and on the stock certificate, it would be wise for the stockholders to embody it in a stock agreement and in the by-laws. The restriction may be done away with by an amendment, the articles of incorporation which amendment requires only a two-thirds vote of the stocks.[84] On the other hand, a stockholders' agreement will be binding on all stockholders parties to it and cannot be changed against the objection of even only one of them. Inclusion in the by-laws will be an added precaution. Although failure to do so will not affect the validity of a restriction otherwise valid, its presence in the by-laws will serve as a constant reminder to directors and corporate officials of its existence.

Conclusion

From all the foregoing, one can deduce what a lawyer who is drafting a stock transfer restriction should guard against to avoid the pitfall of having the restriction declared void later. Although the safest method would seem to be the option restriction requiring the stockholder to first offer the stocks to the corporation or to the other stockholders before he can sell or transfer the same to others, the particular need of the circumstances obtaining in a case may make another method more feasible. Perhaps a combination of two or more methods will be necessary. The draftsman must also keep in mind that although a restriction may be justified by the circumstances, since it is an exception to the fundamental principle of free alienability of property, its terms will most likely be strictly construed.[85] In any case, the intended coverage must be clearly specified so that the purpose of the restriction will not be easily thwarted. The

[83] See Evans v. Dennis et al., 46 S.E. 2d 122 (1948); Model Clothing House et al v. Dickinson et al., 178 N.W. 951 (1920); Sterling Col v. Litel, 223 P. 753 (1924); Fairfield Holding Corp. v. Southis, 155 N.E. 639 (1927).

[84] See for example Silva v. Coastal Plywood & Timber Co., 268 p. 2d 570.

[85] Oakland Scavenger v. Gandi, *supra;* McDonald v. Farley & Loetscher Mfg. Co., *supra;* Brown v. Little, Brown & Co., Inc., 168 N.E. 521 (1929).

option restriction, when adopted, should state what events will give rise to the option—e.g., transfer, death, or termination of employment. It should also specify what transfers are subject thereto. If it is to achieve its purpose, it should expressly be applicable to all transfers —e.g., voluntary sales, judicial sales, pledges, transfer by one stockholder to another, etc. The person in whose favor the option runs should be stated, whether it be the corporation or the other stockholders or either of these successively. If the optionees are the stockholders, then the restriction should specifically state whether each is entitled to purchase in proportion to his holdings, or in equal shares, or whether any one of them may exercise the option as to all the offered shares on a first-come-first-served basis. If the option to take is to be proportional to a stockholder's current holdings, provision should also be made for the eventuality of one or more of the shareholders not taking the option. It should also state the procedure to be followed in making the offer, the period of time within which the option may be exercised as well as how long after the taking of the option should the purchase price be paid and the transfer accomplished. A clear statement on these matters will avoid disputes as to when the stockholder will be free to sell to outsiders.

The transfer price should also be provided for, or a method for arriving at such price should be carefully outlined in sufficient detail. Leaving the transfer price to negotiation at the time of the transfer may give rise to more serious problems than providing for its determination ahead of time when the buyer and seller are still unknown.

It goes without saying that when restriction is a necessity, a poorly drafted one is almost as bad as having no restriction at all. On the other hand, a judiciously and carefully drafted restriction the terms and conditions of which are reasonably justified by the circumstances surrounding the corporation and its stockholders, will assure the parties involved in a close corporation that their time, effort and funds, spent in building up their business from practically nothing to a prosperous going concern will not fall into the hands of the wrong persons.