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COMMENTS

STOCK TRANSFER RESTRICTIONS AND THE CLOSE CORPORATION—A STATUTORY PROPOSAL

By Gilbert N. Kruger*

INTRODUCTION—THE CLOSE CORPORATION

The importance of the closely held corporation (also known as the family corporation and the “incorporated partnership”) seems to have been obscured by the shadow of its big brother, the publicly held corporation. Although the earliest corporations were in reality “incorporated partnerships,” formed to attain limited liability for the incorporators, it was the growth in stature of the larger, publicly held corporations at which legislation was directed. It was only natural that statutes were designed to protect the investing public as the gap between ownership and management in publicly held corporations grew wider.

Unfortunately however,

Statutes and judicial decisions, in laying down rules for the governance of corporations, have not distinguished between public issue and close corporations. As the nature and methods of operations of publicly held and closely held corporations are utterly different, the result has been that many of the concepts and principles of corporate law (undoubtedly developed with public issue corporations primarily in mind) are ill-adapted to closely held enterprises. In Great Britain and the countries of continental Europe, “private” companies are governed by special legislative rules; but in this country, as a general proposition, the same rules are applied to all corporations indiscriminately.

The close corporation is a highly desirable business form which has achieved widespread existence despite the comparative matten- tion paid to it by legislatures and courts. It is largely due to the ingenuity of the corporate attorney that the close corporation has developed and gained acceptance. Although divergent approaches have

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* Member, Third Year Class.
2 Id. at 701.
3 Ibid.
been used in attempts to define a close corporation, the singular intent has been to differentiate it from the publicly held corporation.4

Although there are several distinguishing features of importance, two are most significant. A close corporation is generally characterized by identity of ownership and management, as the shareholders have a direct hand in corporate administration. In the publicly held corporation, on the other hand, the shareholders have practically nothing to do with the management of corporate affairs. Management is left to the board of directors, which is elected by the shareholders for this purpose. Additionally, since the “partners” work intimately in the daily operation of the business, they must be free to choose their own associates. It is a necessity in the close corporation that the parties mold themselves into a cohesive work group. Shares in the publicly held corporation must be freely transferable because they are sold to the investing public. This requirement of free transferability naturally eliminates the possibility of selecting one’s co-owners in the publicly-held corporation. There would seem to be no good reason why the shareholders of the publicly held corporation would want to choose their co-shareholders, while in the close corporation the opportunity to choose is essential.

The striking resemblance between a partnership and a close corporation is the source of the phrase “incorporated partnership.” The close corporation is a business form in which the participants act towards each other as if they were partners, while adopting the corporate form to obtain its advantages. Once this corporate form has been established the conduct of the associates between themselves, as distinguished from what the business entity looks like to third parties and the state, is what really concerns the “partners.” Their desire is to have the close corporation remain close.5 Restricting the availability of shares to outsiders is the most effective way to retain this closeness.

Use of the stock transfer restriction6 in the close corporation is

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4 Winer, Proposing a New York “Close Corporation Law,” 28 CORNELL L.Q. 313 (1943), suggests that a close corporation be defined as one with one to five ultimate shareholders; The English Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 28(1)(b), defines a “private” company (close corporation) as one which “limits the number of its members to fifty.” Under the INT. REV. CODE OF 1954, § 1371(a)(1), “a small business corporation” is defined as one “which does not have more than 10 shareholders.”

5 An early and classic statement to this effect is one by Holmes in Barrett v. King, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902)—“Stock in a corporation is not merely property. It also creates a personal relation analogous otherwise than technically to a partnership. [T]here seems to be no greater objection to retaining the right of choosing one’s associates in a corporation than in a firm.”

6 A partial bibliography of materials dealing with stock transfer restrictions and
indispensable for insuring continued closeness. It is the purpose of this comment to examine the stock transfer restriction in light of its importance to the close corporation, and to indicate the need for legislative attention to the difficulties attorneys and courts encounter in working with stock transfer restrictions under present statutes and precedents.

That the subject is of more than academic interest is underscored by the fact that there are at present in excess of 18,000 new corporate filings each year in California alone. Although separate figures for close corporations are not available it is highly probable that the great majority of filings are for closely held corporations.

THE STOCK TRANSFER RESTRICTION IN RELATION TO THE CLOSE CORPORATION

Stock transfer restrictions have been aptly referred to as "a sort of pre-emptive right." Most commonly, either the existing stockholders or the corporation or both in succession are given the first opportunity to purchase the shares offered by a selling shareholder. The effect of this first option or right of first purchase is to give the existing shareholders the power to "veto the admission of a new participant."
Such a restriction can be placed in the bylaws, the articles of incorporation, or a shareholders' agreement.

Although the phrase "preemptive right" is associated in corporation law with the right of shareholders to have the first opportunity to buy new stock issued by the corporation, exercising rights under a stock transfer restriction is also a preemptive right. In the close corporation the right of first purchase is given to the corporation or the shareholders or both in succession and generally applies to shares which have already been issued. In the publicly held corporation, the preemptive right (where it exists) invariably extends to new issues of shares and runs only to the existing shareholders. Putting these distinctions aside, it is clear that rights created by the stock transfer restriction are preemptive rights.

Not all stock transfer restrictions are valid. The earliest cases concerning transfer restrictions in the United States held them invalid. The theory was that a share of stock is a property right and the restriction amounts to an unreasonable restraint on the alienation of property. On the other hand, "English law has always regarded shares of stock as creatures of the company's constitution and therefore as essentially contractual choses in action," not subject to the rules against restraints on alienation.

The present test for validity of a stock transfer restriction is whether it is reasonable. It cannot amount to a total prohibition against transfer because of the rule against restraints. Additionally, many courts hold unreasonable, on public policy grounds, stock transfer restrictions which give the present shareholders or the board of directors the power to veto the admittance of a new shareholder.

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14 LATTTIN, CORPORAIONS 424 (1959).
15 According to Blackstone, the King "had the profitable prerogative of purveyance and pre-emption: which was a right enjoyed by the crown of buying up provisions and other necessaries, by the intervention of the king's purveyors, for the use of his royal household, at an appraised valuation, in preference to all others, and even without consent of the owner." 1 JONES' BLACKSTONE 418 (1915).
19 The American courts have been in conflict on this point, although the later cases seem to sustain the validity of these "consent restraints." See O'Neal, Restrictions on the Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 HARV. L. REV. 773, 780 (1952).
There is no doubt that today in the United States reasonable stock transfer restrictions (such as rights of first purchase held by the corporation or the shareholders or both) are almost everywhere held valid.\(^{20}\) Now that the validity of reasonable restrictions has become firmly entrenched, recent cases indicate a shift of emphasis. Present attention seems to be focusing on a determination as to whether amendments to bylaws or articles of incorporation, either adopting restrictions for the first time or eliminating those already included, are valid.\(^{21}\) A second broad area of difficulty is one that has been present from the beginning—judicial interpretation of the language used in creating the restrictions. The material to follow will analyze each of these problem areas in turn, and a statutory solution will be suggested.

### ADDING OR DELETING STOCK TRANSFER RESTRICTIONS BY AMENDMENT

An examination of some recent cases, principally cases from California, will illustrate the difficulty of adding or deleting stock transfer restrictions by amendment of the bylaws or articles.

*Casady v. Modern Metal Spinning & Mfg Co.*\(^{22}\) involved a close corporation whose bylaws contained a typical right of first purchase. Plaintiff had brought a divorce proceeding against her husband, who owned one half of the corporate stock. A property settlement agreement declared that plaintiff should be entitled to one half of the shares held by the husband. The corporation refused to issue the shares to plaintiff, pointing to the stock transfer restriction in the bylaws. The district court of appeal refused plaintiff’s request for a court order to force a meeting of the board of directors for the purpose of voting to delete the restriction. The court relied on an earlier line of cases\(^{23}\), which also refused amendments of the bylaws even though a statute\(^{24}\) explicitly permits amendment. The rationale was that some bylaws create contractual rights which cannot be destroyed without the consent of all the parties to the agreement.\(^{25}\)

In *Silva v. Coastal Plywood & Timber Co.*\(^{26}\) the articles of incor-

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\(^{20}\) Id. at 780-81.


\(^{22}\) 188 Cal. App. 2d 728, 10 Cal. Rptr. 790 (1961).


\(^{24}\) CAL. COMP. CODE § 501(g).

\(^{25}\) 188 Cal. App. 2d 728, 734, 10 Cal. Rptr. 790, 794 (1961).

poration provided that only one share of stock could be issued to or owned by any stockholder. The corporation had financial difficulties and filed for reorganization under Chapter X of the Bankruptcy Act. Plaintiffs, the minority shareholders, sought an injunction against proposed majority-shareholder action eliminating the restrictions. The corporation was organized under the laws of Nevada. The district court of appeal upheld the majority's action in amending the articles to eliminate the restriction. Under the Nevada statute, which is to the same effect as that of California, amendments to the articles are permitted. Since the amendment fell within the scope of the statute it was held valid, notwithstanding the minority's claim that they had a vested contractual right in retaining the restriction.

As stated by the court in *Tu-Vu Drive-In Corp. v. Ashkins*, "This case presents the issue of whether a corporation may enforce a bylaw restricting the alienation of stock against a non-consenting shareholder who acquired his stock prior to the enactment of the bylaw." Neither the original articles nor bylaws contained any stock transfer restrictions. The supreme court upheld the action of the board of directors in amending the bylaws to include a restriction after the minority shareholder, defendant in this declaratory judgment action, attempted to sell the shares to a business competitor. The court based its decision on two sections of the California Corporations Code. Section 500 permits amendments of the bylaws and section 501(g) permits "reasonable restraints upon the right to transfer or hypothecate shares" in the bylaws. Most of the opinion was devoted to determining whether the restriction was "reasonable" as required by section 501(g). A two-pronged test was set forth: first, whether the restriction would be a prohibitive restraint on the right of alienation and second, whether the restriction would "unreasonably deprive the shareholder of 'substantial rights.'" Both tests were resolved in

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28 Nev. Rev. Stat. § 78.385(1)(c) (1957) provides that a corporation may amend its articles of incorporation by "increasing, decreasing or reclassifying its authorized capital stock by changing the number, par value, designations, preferences or the qualifications, limitations or restrictions of its shares."
31 Id. at 284, 38 Cal. Rptr. at 349, 319 P.2d at 829.
32 Cal. Corp. Code § 500 provides in part: "By-laws may be adopted, amended or repealed by the vote or the written assent of shareholders entitled to exercise a majority of the voting power of the corporation."
33 Cal. Corp. Code § 501 provides: "The by-laws of a corporation may make provisions not in conflict with law or its articles for: (g) Special qualifications of persons who may be shareholders, and reasonable restrictions on the right to transfer or hypothecate shares."
34 61 Cal. 2d at 286, 38 Cal. Rptr. at 350, 391 P.2d at 830 (1964).
favor of the action which had been taken by the board of directors—the first because a right of first purchase is not “unreasonably restrictive” and the second because the purpose or benefit to the corporation (preventing the sale of shares to a business competitor) outweighed the impairment of the rights of the complaining shareholder to hold his shares free of the restriction.

Each of these cases involved a determination as to whether, at a date subsequent to incorporation, the bylaws or articles could be amended either to delete or add stock transfer restrictions. It has been found difficult to reconcile the opinions in these decisions. As a matter of generalization it seems safe to say that the California courts have attempted to reach desirable results by choosing from among several available approaches, none of which is directly applicable.

In Casady, the court refused to order the deletion of the stock transfer restriction from the bylaws, apparently feeling no compelling need to disrupt the corporate structure in order to satisfy the terms of a property settlement agreement. The court emphasized the contractual nature of stock transfer restrictions. Where an amendment of articles to eliminate a stock transfer restriction was necessary to effectuate a program of corporate reorganization, as in Silva, the court upheld the deleting amendment. Here reliance was placed on statutory language permitting amendment of the articles. In Tu-Vu, the court upheld an amendment of the bylaws creating a stock transfer restriction not found in the original bylaws. In so doing, it forestalled a potential transfer of a minority shareholder’s interest to a business competitor. Here, as in Silva, stress was put on the language of the statute permitting amendment.

It is interesting to note that the court in Casady failed to cite the Silva case, while the court in Tu-Vu relied on Silva, but omitted any reference to Casady. It would appear that these cases were all similar enough to merit at least a distinguishing discussion.

In the light of the Tu-Vu decision, would the California Supreme Court reach the same result where the bylaw amendment induced by the majority shareholder was designed to prevent a transfer of shares to a fellow shareholder rather than a business competitor? The court in Tu-Vu stated that

Bylaws restricting transfer in closed corporations are frequently essential to a successful enterprise; they perform an important function in precluding unwanted intrusions by outsiders; they preserve the integrity of the functioning entity. Such bylaws are “necessary

Ibid.


CAL. CORP. CODE § 501(g) provides that stock transfer restrictions may appear in the bylaws, but there is no specific indication that they may be adopted by amendment at a date subsequent to incorporation.
for the protection of the corporation and its stockholders against rivals in business or others who might purchase its shares for the purpose of acquiring information which might thereafter be used against the interest of the company. 38

A court faced with this variation of the Tu-Vu situation would have to decide whether a transfer to another stockholder, rather than a business competitor (as in Tu-Vu), was sufficiently harmful to the corporation to justify the bylaw amendment. Such a determination might present a difficult factual problem for the court. An alternative approach would be to hold the bylaw amendment sanctioned by statute and dispense with the case on this ground, as was done in Silva and Tu-Vu.

A second modification of the Tu-Vu fact pattern would appear to present an even greater potential problem. In Bechtold v. Coleman Realty Co. 39 the court was faced with the question of determining whether a majority shareholder could induce an amendment to the bylaws which would delete a stock transfer restriction. The majority shareholder's purpose in doing this was to sell to an outsider who was not a business competitor of the corporation. The court in Bechtold divided corporate bylaws into two classes, (a) those that are merely regulatory and (b) those that are in the nature of a contract which vests property rights in all the shareholders. 40 The stock transfer restriction was placed in the second class, thereby preventing its deletion without the consent of all the other stockholders whose rights were affected. 41 Would the California supreme court reach the same result? It will be remembered that in Silva the court upheld an amendment of the articles eliminating a stock transfer restriction because such an amendment was sanctioned by statute as a regulatory matter. Although that decision would be good case law precedent for the same result here, it is doubtful whether the California supreme court would follow the rationale of Silva in this situation. In Silva the corporation was reorganizing under the Bankruptcy Act and it was essential that new stockholders with fresh capital be admitted. No corresponding need is present under these facts.

A possible basis for rejecting the amendment deleting the restriction would be to hold, as did Bechtold, that the minority shareholders had a contractual or "vested" right to hold their shares with the restriction intact. The district court of appeal upheld the minority shareholder's "vested right" contention in Tu-Vu. 42 The California supreme

38 61 Cal. 2d at 287, 38 Cal. Rptr. at 350, 391 P.2d at 830. (Emphasis added.)
40 367 Pa. at 213, 79 A.2d at 663 (1951).
41 Ibid.
42 The trial court found that the minority shareholder had a vested right to hold
The court reversed the district court of appeal, holding that "The shareholder thus acquires his shares subject to the power of the corporation to alter its contract with him pursuant to statutory authority."\(^{43}\) This broad statement rejecting the argument that certain bylaws create contractual rights would apparently foreclose the supreme court from protecting the minority shareholders on this basis, should the Bechtold case arise in California.

The court's strongest position in refusing the proposed amendment might be to hold that the majority shareholder owes a fiduciary duty to the minority shareholders. The invocation of this equitable principle in many analogous cases represents a growing trend in corporation law.\(^{44}\) Using this approach, the court would look to the good faith of the majority shareholder and could set aside the attempted elimination of the stock transfer restriction on the basis of a finding of unfair dealing for personal gain. "But fraud and fair dealing are unfortunately not self-explanatory; even sensitive consciences will vary in their reaction to a given situation."\(^{45}\) In other words, here too the court would be faced with a difficult factual determination.

The element common to each of the above fact situations was the absence of statutory language which definitively dealt with all of the facts. The courts were forced to deal with corporation statutes satisfactory for handling ordinary amendments of bylaws or articles but entirely inadequate in coping with the particular problem of amendments concerning stock transfer restrictions. One might ask at this point, in light of the importance of stock transfer restrictions, why statutes bearing on the problem have not been enacted. The answer simply is that this phase of corporation law is in its rudimentary stage.

It has only been in the last twenty years or so that the close corporation's plight has been noticed to any appreciable extent in the United States.\(^{46}\) The initiative was taken by scholars who brought the problem to light with the intention of effecting corrective legislation.\(^{47}\) They must be given credit for some of the recent enactments aimed at aiding the close corporation. Suggested drafts of comprehensive close corporation statutes, however, have usually been rejected be-

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43 Tu-Vu Drive-In Corp. v. Ashkins, 34 Cal. Rptr. 622 (1963).
45 Frey, Shareholder's Pre-Emptive Rights, 38 YALE L.J. 583, 583 (1929).
46 O'Neal, Developments in the Regulation of the Close Corporation, 50 CORNELL L.Q. 641 (1965).
47 Ibid.
cause of a single factor—the perplexing problem of defining a close corporation. North Carolina has met this difficulty by defining a close corporation as being one whose shares are not "generally traded in the markets maintained by securities dealers or brokers." Florida has followed suit, but the rest of the states have not, probably because they are not convinced that this approach is satisfactory.

It is submitted that an alternative approach to the problem of amendments of bylaws or articles affecting stock transfer restrictions is possible. As is the case in other situations where piecemeal legislation has been directed at the close corporation, it is feasible to word a statute so that only a close corporation could avail itself of its terms.

Thus, a statute could be drawn whose language simply states that if those forming a corporation desire stock transfer restrictions as part of the corporate form, they must provide for the restrictions in the articles of incorporation. The proposed statute would state that only restrictions found in the articles, either as originally drawn or as amended, will be valid. If a corporation desires to make use of the stock transfer restriction, it must do so by following the statute’s directions. Provisions for stock transfer restrictions in any other manner will not suffice. It should be stressed that choosing to include stock transfer restrictions is a completely elective process. Obviously, only a close corporation could (or would) avail itself of this procedure. Yet a close corporation never has to be defined. Those states which have sympathized with the close corporations’ predicament, but have not taken action because of the definitional problem, could readily adopt the proposed statute.

The above discussion indicates that a uniform method of adopting

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48 The New York Law Revision Commission debated the matter of defining a close corporation for the purpose of enacting a close corporation law but decided against such a measure. As stated in the report, “no satisfactory way of defining the genuine close corporation for purposes of a statute has been found. Economically, the distinction between a close corporation and any other is that in the close corporation management and ownership are substantially identical, but the only way in which it appeared to the Commission that a definition could be embodied in a statute would be to limit the amendment to corporations having not more than a stated number of shareholders, or not more than a stated amount of capital. This would necessarily be arbitrary, might not provide an answer to the economic problem, and would possibly permit a single shareholder by splitting up of his shareholding to break up the arrangement at will unless the remaining shareholders or the corporation bought him out.” 1948 N.Y. LAW REVISION COMM’N REP. 386 (1948).


51 See, e.g., N.Y. Bus. Corp. Law § 610, growing out of the famous case of Bemontendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945), and Cal. Corp. Code § 500, which allow the incorporators to provide for more than a bare majority vote to transact corporate business.

52 See Appendix for § 1 of the proposed statute.
and eliminating stock transfer restrictions is needed. Corporate attorneys drafting stock transfer restrictions are entitled to know beforehand, with some degree of certainty, the basis on which the courts will judge the restrictions. Courts, on the other hand, need explicit statutory guidance. Applying this principle to the cases discussed, the court would merely have to determine whether the adoption or elimination of the stock transfer restriction complied with the proposed statute's instructions.

There is no magic in including stock transfer restrictions in the articles of incorporation rather than the bylaws. The desired uniformity could be achieved by inclusion in either place. But greater solemnity is generally required to amend the articles and the proposed statute would properly take advantage of this requirement. Since maintaining the closeness of the close corporation is a major premise upon which the corporation is formed, the articles, either as originally drawn or as amended, should reflect this intention.

Another section of the proposed statute indicates the method by which an amendment of the articles either to include stock transfer restrictions not found therein originally, or to eliminate restrictions originally included, shall be made. If the corporation is composed of four or fewer shareholders, a unanimous vote of all voting shares would be required. In a corporation with five or more shareholders, a two-thirds vote of the voting shares would be required. The number of shareholders delimiting each group was chosen arbitrarily, but with a definite intention. If the corporation is really small (four or fewer shareholders), it closely resembles the typical partnership, and it is therefore fair to require unanimous action to include or eliminate stock transfer restrictions. When the corporation becomes larger, the process of unanimous vote becomes unwieldy because the whim of a single shareholder could block action. Thus the unanimous vote requirement is dropped. But to prevent action by a bare majority (as was the case in Tu-Vu) a two-thirds vote is necessary.

Any statute directed at stock transfer restrictions should indicate what types of restrictions are approved. The proposed statute san-

53 Aside from this determination, the court would also have to pass upon the reasonableness of the restriction. This is to make sure that it does not amount to an unreasonable restraint on alienation.

54 Usually statutes require filing of amendments to the articles of incorporation. There is no corresponding rule for amendments to the bylaws. In addition, amending the articles usually requires action by the board of directors and by the shareholders. Bylaws may often be amended by the shareholders or the board of directors. Compare Cal. Corp. Code § 3832 with Del. Code Ann. tit. 8, § 109 (1953).

55 See Appendix for § 1(b) of the proposed statute.

56 See note 51 supra for examples of statutes with analogous more-than-majority voting requirements.
tions typical rights of first purchase running to the benefit of the shareholders or the corporation or both in succession, restrictions giving the corporation the right to purchase the shares of a shareholder-employee whose employment is terminated, and restrictions which give the shareholders the right of first purchase of shares held by the corporation and subsequently offered for sale.57 The language of the proposed statute indicates that the restrictions listed are not intended to be exclusive.

The right of first purchase enjoyed by the corporation or the shareholders or both in succession is the most commonly used and accepted. Whether the prospective purchase is occasioned by a shareholder's fortuitous present intent to sell his shares, or occasioned by a sale pursuant to his retirement, death, or incapacity to participate in the business, the purpose to be served by the restriction is the same—to retain the original closeness and balance of power. In practice the corporation is usually given the first option to purchase. The practical effect of this provision is that the remaining stockholders retain their percentage of control, pay no money personally, and have the stock retired. If the corporation is unable to make the purchase, the shareholders are given the second option.

Where the corporation purchases its own shares, two points should be kept in mind, although they are not dealt with in the proposed statute. First of all, corporation statutes often provide that a corporation may purchase its own shares only out of earned surplus.58 There is a strong legislative policy behind this requirement59 which the proposed statute does not attempt to override. Those drafting stock transfer restrictions under the proposed statute would find it necessary to research the other corporations statutes on this point.

The second point is closely akin to the first. It is sometimes provided by statute that if a corporation desires to purchase its own shares it must make provision for this in the articles of incorporation.60 Here again, it would be necessary to research the other corporations statutes to verify the applicable law.

The purchase (by the corporation or the shareholders) of the shares of a shareholder-employee whose employment is terminated serves just as useful a purpose as that described immediately above. The associates in the close corporation will usually want to "restrict employee shareholdings to those currently employed to protect the

57 See Appendix for § 2 of the proposed statute.
58 See, e.g., CAL. CORP. CODE § 1707(c).
59 "The purchase or redemption of its shares by a corporation constitutes a withdrawal of assets and should be restricted to some reasonable limits of safety for the protection of creditors and other shareholders." LATTIN & JENNINGS, CASES ON CORPORATIONS 1211 (3d ed. 1959). See also CAL. CORP. CODE §§ 1705-08.
60 See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 5 (1953).
corporation from disgruntled former employees) 61 This desire has been given effect by the courts and is entitled to legislative sanction. 62

The third approved restriction in the proposed statute is that which gives the existing shareholders the first opportunity to buy shares which the corporation has reacquired and later intends to sell. Since the sale of shares to outsiders by the corporation is just as destructive as sales by the shareholders, careful draftsmen will often insert such a restriction.

A notable exception to these sanctioned stock transfer restrictions is the "consent restraint." The consent restraint is a method by which the shareholders or the board of directors are given the power to veto a proposed transfer of shares to a third party. Usually, the restraint specifies that the veto must be exercised on reasonable grounds. There are three reasons why the consent restraint was omitted from the proposed statute: (1) There are strong policy arguments against consent restraints and these arguments have prevailed in many jurisdictions; 63 (2) requiring courts to determine whether the veto was "reasonably" exercised creates a litigation-breeding situation; (3) a right-of-first-purchase restriction is all the protection the shareholders need anyway. 64

PROBLEMS OF JUDICIAL INTERPRETATION OF STOCK TRANSFER RESTRICTIONS

It is probable that the great majority of cases involving stock transfer restrictions entail judicial construction of the language used

61 1 HORNSTEIN, CORPORATION LAW AND PRACTICE 248 (1959).
62 Ibid.
63 The older cases took the position that consent restraints were unreasonable restraints on the right of alienation of personal property. See, e.g., Morris v. Hussong Dyeing Mach. Co., 81 N.J. Eq. 256, 86 Atl. 1026 (Ch. 1913); In re Klaus, 67 Wis. 401, 29 N.W. 582 (1886). Most of the recent cases uphold consent restraints, although their validity is still in doubt in many jurisdictions. See O'Neal, Restrictions on Transfer of Shares in Closely Held Corporations: Planning and Drafting, 65 HARV. L. REV. 773, 780 (1952).
64 A right of first purchase is often provided for in situations where a judgment creditor of a shareholder seeks to levy execution on the shares in satisfaction of the judgment. This type of restriction was not included in the statute as an example of a sanctioned restriction even though it is generally held valid. The difficulty involves a determination of the price to be paid to the judgment creditor to prevent his getting hold of the shares. It is anticipated that the requisite statutory language would be cumbersome and, since these restrictions are commonly upheld by the courts when properly drafted, no real hardships should result from their omission from the proposed statute. The list of restrictions in the proposed statute is expressly stated to be illustrative and not inclusive.
in creating the restrictions.\textsuperscript{65} The proposed statute attempts to deal with these problems.

The stock transfer restriction agreement will state the time limit within which the stockholders or the corporation must elect whether or not to exercise this right of first purchase. Confusion sometimes occurs because of the failure to specify the date upon which the period begins to run. \textit{Allen v. Biltmore Tissue Corp.}\textsuperscript{66} illustrates the judicial approach to this situation. The bylaws provided for a right of first purchase both during the life of the stockholder and in case of death as follows: "Should the option provided for in this section not be exercised, then, after the lapse of ninety days, the legal representative may dispose of said stock as he sees fit."\textsuperscript{67}

As stated by the court, "the section is patently deficient in omitting to specify the date upon which the 90-day period is to commence."\textsuperscript{68} Decedent died on October 25, 1953. In February of 1954 the corporation was informed of his death. Biltmore's board of directors voted to exercise the option on March 4, 1954 and notified the executor's attorney of their action on March 23, 1954, nearly five months after decedent's death. The court held the corporation acted within the permitted ninety-day period since it could act only after receiving notice and this occurred in February, 1954.\textsuperscript{69}

Section 3(a) of the proposed statute\textsuperscript{70} attempts to anticipate these situations by providing that the option period begins to run upon the receipt of written notice. Since small corporations may not ask for the advice of counsel in all instances, it was considered better not to burden the transferor with the technicalities of registered or certified mail. Certainly this latter method is more desirable as providing more reliable proof, but the proposed statutory procedure should suffice.

Every stock transfer restriction agreement specifies a time limit within which the right of first purchase must be exercised. The periods chosen vary according to the individual situation. Section 3 of the proposed statute\textsuperscript{71} provides for this factor by enabling the draftsman to select the limitation suitable to his client's needs. If no period is provided, the proposed statute sets an outer limit of forty-five days where the corporation is the potential transferee and thirty days where the shareholder is in this position. The purpose in choosing two different periods recognizes the greater amount of time corporate ac-
tion requires. Since the most common stock transfer restriction provides for alternative rights of first purchase in the corporation and the shareholders, section 3(b) of the proposed statute provides for two statutory periods. If the first potential transferee exercises the purchase right, there is no need for the second period to run. Where the first potential transferee does not exercise the purchase right, the second period begins to run the day after the first period expires.

Questions sometimes arise as to who will be bound by the stock transfer restriction agreement. Where, for example, shares come into the hands of an executor or pledgee, judicial construction of the agreement’s terms is necessary if the language is not explicit. The proposed statute assumes that draftsmen always intend that the broadest possible scope be given stock transfer restrictions. Section 4 of the proposed statute makes it clear that, unless provided otherwise, the stock transfer restriction adheres to every share of stock of the corporation. Whether the shares are in the hands of the shareholders, the corporation, or third parties, the stock transfer restriction binds the shares. The broad language is intended to fasten to shares in any status. Thus treasury shares, authorized but unissued shares, issued shares, and new issues are all subject to the restrictions.

It is important to note that even under such a statutory provision, the intent of the incorporators may be defeated unless additional safeguards are provided. If the corporation has a number of authorized but unissued shares, the majority shareholders may be able to dilute the percentage ownership of the minority by voting to issue these shares at a time when the minority is not in a financial position to purchase. The majority may purchase the shares themselves and thereby increase their percentage ownership at the expense of the minority. Section 4 of the proposed statute would be of no help to the minority group. The provision states that when authorized but unissued shares are subsequently issued, the stock transfer restriction will attach automatically to these shares—but there is no requirement restricting the majority from causing the shares to be issued at any time it decides is appropriate. In other words, although the transfer restrictions will attach to these shares there is nothing in the statute which prevents the majority from effectively insuring, by taking advantage of economic circumstances and its voting power, that these shares go only to majority shareholders.

To protect against issuance of shares which would alter corporate control, the draftsman should give the shareholders an opportunity to

72 Ibid.
73 Ibid.
74 Here, too, the court might hold the majority shareholders to a fiduciary duty to the minority.
reject the issuance of previously authorized, but as yet unissued, shares. This could be accomplished by a provision in the articles of incorporation which requires, perhaps, a two-thirds vote for approval of the issuance. Since treasury shares can also be sold to outsiders, the same procedure would be applicable here.

Another way for the majority shareholders to disrupt the original balance of power would be to authorize a new issue of shares. As the judge-made equitable doctrine of shareholders preemptive rights evolved, the existing shareholders had a preemptive right to purchase any new issue of shares on a pro rata basis, and, therefore, under this rule there would be no difficulty. There is a dangerous pitfall in California, however, because under the Corporations Code there are no preemptive rights unless provided for in the articles of incorporation. Thus, as in the case of authorized but unissued shares, the majority could dilute the minority's interest by authorizing the new issue at a time which is financially inconvenient for the minority. To carry out the associates' intent, two provisions should be made in the articles: (1) by analogy to the authorized-but-unissued situation, the shareholders should be given the opportunity to vote down a proposed new issue and (2) the existing shareholders should be given a preemptive right to purchase newly issued shares.

One of the main objectives of the proposed statute is to have the stock transfer restriction become a part of every share of stock of the close corporation. This objective is designed to help achieve the ultimate goals of keeping the close corporation close and maintaining the balance of power. The corporate draftsman should take complementary action by protecting against the foreseeable problems of authorized but unissued shares, treasury shares, and new issues.

It has already been indicated that maintaining the original balance of power is often as important to the associates as preventing intrusions by outsiders. This objective attained by a clause which gives the shareholders the right of first purchase on a pro rata basis; i.e., a right exercisable in proportion to their existing interests. The rule of narrow construction of stock transfer restrictions, however, has led to defeat of the parties' intent where the wording of the restriction has been subject to doubt.

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78 CAL. CORP. CODE § 1106 provides: "Unless the articles provide otherwise, the board of directors may issue shares, option rights, or securities having conversion or option rights, without first offering them to shareholders of any class."
79 Although again the majority might be held to a fiduciary duty.
80 See Appendix for § 5 of the proposed statute.
Guaranty Laundry Co. v. Pulliam81 is illustrative of the problem. The stock transfer restriction was included in a shareholders' agreement which provided that if an event one shareholder should consider selling his shares, he would "give the remaining stockholders or stockholder, the first and last chance to purchase his stock."82 The issue was whether a sale of all the shares to one shareholder satisfied the terms of the agreement. Following the rule of narrow construction, the court held that "we conclude that it may reasonably be construed that the agreement was satisfied by sale to a remaining stockholder, as well as to all of the remaining stockholders."83

Because of the rule of narrow construction typified by the Pulliam case and because it must be presumed that the draftsman's intent is to maintain the original balance of power, a pro rata exercise of the right of first purchase is the rule under section 5 of the proposed statute, unless provided otherwise.

Section 15 of the Uniform Stock Transfer Act,84 which is intended to be superseded by section 8-204 of the Uniform Commercial Code,85 requires a notation on the face of the stock certificate that the shares are subject to transfer restrictions. The Uniform Commercial Code changes the old rule in two respects: (1) a transferee with actual knowledge of the restriction will be bound by it even in the absence of notation on the shares and (2) the notation must be conspicuous.86 Section 6 of the proposed statute, which refers to the Uniform Commercial Code, is intended merely as a reminder that these rules must be complied with.87

The proposed statute does not indicate any method by which the price to be paid for the transfer of shares under a stock transfer restriction shall be determined. Fixing the value of shares of a close corporation has been a continuing, thorny problem.88 The difficulty


82 Id. at 670, 181 P.2d at 1009.
83 Id. at 670, 181 P.2d at 1009.
84 UNIFORM STOCK TRANSFER ACT § 15 reads: "There shall be no restriction upon the transfer of shares unless the restriction is stated upon the certificate."
85 UNIFORM COMMERCIAL CODE § 8-204 reads: "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it."
86 Ibid.
87 If, for any reason, a state which adopts the Uniform Commercial Code elects not to adopt § 8-204 and repeals the Uniform Stock Transfer Act, then § 6 of the proposed statute would not have to be complied with.
88 See Forster, Valuing a Business Interest for the Purposes of a Purchase and Sale...
arises because the shares of a close corporation are not traded in the market and therefore their fair market value cannot be readily ascertained. As a result, various formulae have been devised to arrive at a proper valuation; these include book value (either inclusive or exclusive of good will), fixed price, par value, and appraisal.\textsuperscript{89} Unfortunately, none of these approaches has produced a satisfactory result in all situations because each method has its shortcomings.\textsuperscript{90}

Although fixing the price of shares subject to stock transfer restrictions is most important in drafting effective restrictions, it was considered best to omit any reference to valuation in the proposed statute. Instead of adhering to one particular valuation method prescribed by the statute the draftsman will be free to choose the price formula best suited to the particular situation.

**CONCLUSION**

As long as legislatures consider that it is not possible adequately to define the close corporation, comprehensive closely-held corporation statutes will not be enacted. Yet present statutes do not sufficiently provide for the needs of the close corporation. The courts and close corporation draftsmen have attempted to reach satisfactory results under these adverse conditions. When the adoption or elimination of stock transfer restrictions at a date subsequent to organization is in issue, the outcome is often speculative. The courts, in attempting to reach desirable results, are free to choose from among several available approaches. Usually, none of these is expressly adapted to stock transfer restrictions in the close corporation, and the results are exemplified in the vacillations of the California courts. When interpretation of the language creating stock transfer restrictions is in issue, many courts feel bound to a rule of narrow construction because of the policy against restraints on alienation.

The proposed statute is directed specifically at stock transfer restrictions in the close corporation. It is intended as a basis for intermediate legislation—somewhere between comprehensive close corporation statutes (which are not too likely to be enacted) and existing statutes (which are not satisfactory). Such intermediate legislation should alleviate some of the existing uncertainties regarding stock transfer restrictions, which are essential elements to the success of the close corporation.\textsuperscript{91}

Agreement, 4 STAN. L. REV. 325 (1952); O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 HARV. L. REV. 773, 797-807 (1952).

\textsuperscript{89} See authorities cited note 88 supra.

\textsuperscript{90} See authorities cited note 88 supra.

\textsuperscript{91} It should be stressed that the proposed statute is not intended to be all-inclusive. It is not a panacea for all the ills involving stock transfer restrictions. The primary
§ 1. For purposes of this article dealing with stock transfer restrictions, as set forth below, such restrictions, to be valid, must be found in the articles of incorporation.  

(a) For purposes of this article only, an amendment to the articles of incorporation, as set forth in part (b) of this section, will be required either to eliminate stock transfer restrictions found in the articles of incorporation as originally filed, or to include stock transfer restrictions at some later date.  

(b) The necessary vote to amend the articles of incorporation under this article dealing with stock transfer restrictions, shall be by unanimous vote of all voting shares in the case of a corporation with four or fewer shareholders and a vote of two-thirds or more of the voting shares in a corporation with five or more shareholders.  

§ 2. Among the types of restrictions on the transfer of shares of stock sanctioned by this article, which are intended to be illustrative and not exclusive, are: rights of first purchase to buy in the corporation or the shareholders or both in succession; rights of first purchase running to the benefit of the corporation to purchase back a terminated employee’s shares; and rights of first purchase running to the benefit of the shareholders to purchase shares held by the corporation and subsequently offered for sale.  

§ 3. Unless the articles of incorporation provide otherwise, the right of first purchase must be exercised or rejected within 45 days if the corporation is an optionee or within 30 days if a shareholder is an optionee.  

(a) The time period specified in this section shall commence upon the receipt of written notice from the transferor.  

(b) Where there are successive rights of first purchase, the second period, if applicable, shall commence the day after the expiration of the first period.  

§ 4. Stock transfer restrictions adopted in accordance with this article shall attach automatically to all shares of stock of the corporation, regardless of the time or manner of issuance, or by whom held, unless the restrictions are eliminated as provided in § 1(a) and (b).  

§ 5. Unless the stock transfer restriction provides otherwise, a right of first purchase in the shareholders is exercisable by the shareholders pro rata.  

§ 6. Any restrictions on the right to transfer shares, as set forth in this article, must comply with the provisions of § 8-204 of the Uniform Commercial Code.  

The function of the proposed statute is to serve as a basis for stimulation of legislative activity.  


93 This section of the proposed statute would only be necessary if the Uniform Stock Transfer Act or the Uniform Commercial Code is in force in the particular state.