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## Corporations - Capital and Stock - Applicability of Restrictions on Transfer of Stock to Transfer Caused by Death

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CORPORATIONS—CAPITAL AND STOCK—APPLICABILITY OF RESTRICTIONS ON TRANSFER OF STOCK TO TRANSFER CAUSED BY DEATH—The stock of the Taylor Trunk Company, with the exception of the two shares now in controversy, was divided equally between two brothers, the remaining two shares having been held by a third brother now deceased. A by-law provided: "That no transfer or sale of the stock of the Company can be made without first offering said stock for sale to the remaining stockholders. . . ." The administrator with will annexed and the legatee of the decedent sought in this action to have the two shares of stock owned by decedent at his death transferred on the books of the corporation to the legatee without first offering to sell the shares to the other stockholders. The circuit court ruled that the corporation did not have to transfer the stock until the by-law had been complied with. From this judgment the administrator and legatee appealed. *Held*, reversed. Although such a by-law is valid, it will be strictly construed and held applicable only to a voluntary sale. *Taylor's Administrator v. Taylor*, (Ky. 1957) 301 S.W. (2d) 579.

Although at present no state has a separate close corporation law,<sup>1</sup> many of our legal standards designed primarily to regulate large public-issue corporations are inappropriate when applied to the close corporation.<sup>2</sup> Thus, those individuals who desire the limited liability of a corporation

<sup>1</sup> As recently as the Spring of 1957 the idea was rejected in New York. See Interim Report of the Joint Legislative Committee To Study Revision of Corporation Laws, Appendix K, 8 McKinney's Session Law News of New York 19 (July 10, 1957). The author did, however, recommend that special consideration be given to the close corporation within the structure of the general corporation statute making particular reference to the adoption of a provision similar to N.C. Gen. Stat. (1950; Supp. 1955) §55-73(b).

<sup>2</sup> For a general discussion see Winer, "Proposing a New York 'Close Corporation Law,'" 28 CORN. L. Q. 313 (1943).

but also the power to select associates and the ability to retain control within this select group characteristic of a partnership must continue to work within the norms prescribed for the publicly held corporation. One of the most burdensome of these norms is the principle of free transferability of shares,<sup>3</sup> which, although quite appropriate and desirable in the large corporation, tends to defeat the purpose of the close corporation. To secure the desired *delectus personæ* and retention of control, resort is commonly had to a restriction on the alienability of the shares. These restraints, which can take many forms,<sup>4</sup> may be expressed in a separate stockholders' agreement, the charter, or, although there exists some authority to the contrary,<sup>5</sup> the by-laws. Since such restraints are in derogation of the principle of free transferability, they were at first held invalid by the courts.<sup>6</sup> However, a growing awareness of the problems of the close corporation has resulted in the general acceptance of a reasonable restraint, such as the "first option" provision employed in the principal case.<sup>7</sup> In spite of this general recognition the use of such restraints is still encumbered by a vestige of the doctrine of free transferability which takes its form in the general policy of the courts to construe such provisions strictly<sup>8</sup> and not to apply them to transactions not expressly referred to therein.<sup>9</sup> Yet, if a first option provision is to fulfill its function it must apply to all dispositions. Therefore, to broaden the coverage of the restriction to encompass all possible changes in ownership, the restraint frequently has been made applicable to all "transfers." A few courts, whose attitude is more in harmony with the needs of the close corporation in this area, have given the word "transfer" the more liberal interpretation necessary to make the restraint truly effective.<sup>10</sup> However,

<sup>3</sup> For statement of general rule see 12 FLETCHER, *CYC. CORP.*, perm. ed., §5452 (1957).

<sup>4</sup> For examples see O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 at 776 (1952).

<sup>5</sup> See STEVENS, *HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS*, 2d ed., §129, p. 601 (1949).

<sup>6</sup> E.g., *Bloede v. Bloede*, 84 Md. 129, 34 A. 1127 (1896).

<sup>7</sup> See *Lawson v. Household Finance Corp.*, 17 Del. Ch. 343, 152 A. 723 (1930); *CHRISTY AND McLEAN, THE TRANSFER OF STOCK*, 2d ed., §39, p. 75 (1940), and cases cited.

<sup>8</sup> See, e.g., *Oakland Scavenger Co. v. Gandhi*, 51 Cal. App. (2d) 69 at 83, 124 P. (2d) 143 (1942).

<sup>9</sup> *Dobry v. Dobry*, (Okla. 1953) 262 P. (2d) 691.

<sup>10</sup> In *Garvin's Estate*, 335 Pa. 542, 6 A. (2d) 796 (1939), where the words "sold or transferred" were used in the by-law, the court said at p. 548: ". . . transfer is a more comprehensive word than sale. Transfer . . . means a change of ownership. . . ." In *Boston Safe Deposit and Trust Co. v. North Attleborough Chapter of the American Red Cross*, 330 Mass. 114, 111 N.E. (2d) 447 (1953), where the words "sale, pledge or transfer" were used, the court held that although title passed to the executor by operation of law he stood in the shoes of the testatrix subject to the same restrictions on transfer and, therefore, had to offer the shares to the corporation before there could be a valid distribution to the legatees. Distinguished in the principal case because of the existence of Ky. Rev. Stat. (1956) §395.230, which authorizes the court to grant a distribution order for stock owned by the deceased upon petition of his personal representative after provision has been made for taxes and if such order would be proper. See also *Kentucky Package Store v. Checani*, 331 Mass. 125, 117 N.E. (2d) 139 (1954).

the position of the court in the principal case in construing the word as applicable only to a voluntary sale is consistent with that adopted in other jurisdictions where the word "transfer" was used alone or in conjunction with the word "sale" and a devolution of title occurred.<sup>11</sup> Similarly, the courts have held that such restrictions do not apply to other involuntary transfers.<sup>12</sup>

It would appear that since the interests of corporate creditors and of the general public are not adversely affected by such partial restraints, and that since the general desire and necessity for such restraints is amply demonstrated by the frequency of their use, the courts could adopt a more liberal attitude in the interpretation of this provision. Until this comes about, however, the solution to this problem lies in carefully drafting the articles and by-laws to include every contingency intended to bring the option into existence. Thus where the by-law or agreement has specifically covered the case of death, it has been held binding on the executor or administrator either as a by-law or a contract.<sup>13</sup>

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<sup>11</sup> *Stern v. Stern*, (D.C. Cir. 1945) 146 F. (2d) 870; *Elson v. Security State Bank of Allerton*, 246 Iowa 601, 67 N.W. (2d) 525 (1955); *Lane v. Albertson*, 78 App. Div. 607, 79 N.Y.S. 947 (1903), where the restriction was in the articles of association of a joint stock company.

<sup>12</sup> *McDonald v. Farley & Loetscher Mfg. Co.*, 226 Iowa 53, 283 N.W. 261 (1939) (sale by receiver pursuant to a court order); *Barrows v. National Rubber Co.*, 12 R.I. 173 (1878) (sale under execution); *Fanchon & Marco, Inc. v. Paramount Pictures*, (S.D. N.Y. 1952) 107 F. Supp. 532, *revd. on other grounds* (2d Cir. 1953) 202 F. (2d) 731, *on remand* (S.D. N.Y. 1955) 133 F. Supp. 839 (transfer pursuant to a decree in an antitrust proceeding); *In the Matter of Trilling and Montague*, (E.D. Pa. 1956) 140 F. Supp. 260 (bankruptcy sale).

<sup>13</sup> *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432 (1894); *Krebs v. McDonald's Ex'x.*, (Ky. 1953) 266 S.W. (2d) 87. See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 (1952).