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CORPORATIONS-RESTRAINTS ON ALIENATION OF STOCK AS AGAINST PLEDGEES WITH NOTICE

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CORPORATIONS—RESTRAINTS ON ALIENATION OF STOCK AS AGAINST PLEDGEES WITH NOTICE—The charter and a by-law of the plaintiff corporation contained provisions which stipulated that before a stockholder could *sell or transfer* any stock, he must first offer the stock to the corporation. The relevant by-law appeared on every certificate of stock. The defendant Kiernan borrowed money from the defendant corporation for which he gave a collateral note secured by the pledge of his stock in the plaintiff corporation. The stock certificate was delivered to the defendant corporation as pledgee. After the default of Kiernan, the plaintiff corporation brought a bill in equity to enjoin the sale of the pledged stock at auction under the power conferred by the pledge. The trial court granted the plaintiff the injunction restraining the sale. *Held*, affirmed. Since the main purpose of the restrictive stipulation was to prevent undesired persons from gaining a right to share in the management of the plaintiff corporation, it was not the intent of those who adopted the stipulation that

it should be circumvented by the device of a pledge and the subsequent sale of a pledgee. *Monotype Composition Co., Inc. v. Kiernan*, 319 Mass. 456, 66 N.E. (2d) 565 (1946).

In the absence of valid restrictions, shares of corporate stock are freely transferable.[1] The freedom of alienation of stock is an attribute which characterizes the concept of corporateness.[2] Yet free transferability of stock should not be an end in itself.[3] Thus, reasonable restrictions upon the power to transfer stock have been accorded legal sanction.[4] What is a reasonable restraint largely hinges on the facts of each particular case.[5] Undoubtedly the law in this area has been inspired in part by concepts which were evolved in the property field. Given the premise that a share of stock is a property interest, the analogy that unreasonable restrictions on transferability are unreasonable restraints on the alienation of property in the estate sense may be too easily and irrationally drawn.[6] Certainly, the validity of restraints on alienation in this field should not be determined by reference to property criteria.[7] Rather, the emphasis should be placed on the fact that an investor must be able adequately to dispose of his shares in order to pro-

[1] BALLANTINE, CORPORATIONS, § 366 at p. 776 (1946).

[2] STEVENS, PRIVATE CORPORATIONS 22, 23, 501 (1936).

[3] Certainly, this problem is raised only in connection with small corporations. Unless one desires to "tilt with windmills," considerations which have to do with restraint of trade or the public interest in the buying and selling of stock are unreal when applied to this area.

[4] For a recent discussion of the tax consequences of restrictive stock agreements see 60 HARV. L. REV. 123 (1946).

[5] In looking at the fact situation to determine whether the restraint is reasonable, factors which have been considered by courts are the size of the corporation, People ex rel. Rudaitis v. Galskis, 233 Ill. App. 414 (1924); the degree of restraint on the power to alienate, People ex rel. Malcolm v. Lake Sand Corp., 251 Ill. App. 499 (1929); the right of the stockholders to determine who shall invest in their business, Baumohl v. Goldstein, 95 N.J. Eq. 597, 124 A. 118 (1924). Emphasis is also placed on whether the control of the corporation is still in the majority of the stockholders, Mason v. Mallard Telephone Co., 213 Iowa 1076, 240 N.W. 671 (1932); whether the business is of the type which requires honest and skilled personnel, Casper v. Kalt-Zimmers Manufacturing Co., 159 Wis. 517, 149 N.W. 754, 150 N.W. 1101 (1915); whether the business is one in which an unfriendly stockholder might injure the corporation, 68 Beacon St., Inc. v. Sohier, 289 Mass. 354, 194 N.E. 303 (1935); whether the limitation upon alienation is necessary or convenient to attain the objects set forth in the charter of the corporation, Lawson v. Household Fin. Corp., 17 Del. Ch. 343, 152 A. 723 (1930). For a category of the varieties of restrictions upon transfers of shares see BALLANTINE, CORPORATIONS, § 336 at p. 776 (1946). For a collection of cases on the subject see 65 A.L.R. 1159 (1930).

[6] See for example the note in 42 HARV. L. REV. 555 at 556, 557 (1929) to the effect that ". . . since shares of stock constitute no exception to the rule that restraints upon the alienation of property are strictly construed, there should be literal compliance with the terms of the power granted in order to affect the rights of subsequent transferees." Francis v. Ferguson, 246 N.Y. 516, 159 N.E. 416 (1927), and Dolph v. Lennon's, Inc., 109 Ore. 336, 220 P. 161 (1923), and 2 THOMPSON, REAL PROPERTY, § 1401 (1924) are cited in a footnote in support of the above statement.

[7] But if a shareholder put a restriction on his shares, property criteria would seem to be applicable.

tect himself against the elements of loss and mismanagement. Is the restraint such a severe burden on the stockholder's freedom of disposition that he has no reasonable way out of the business unit? [8] But in this evaluation process one cannot forget the fact tersely phrased by Justice Holmes that stock in a corporation "creates a personal relation analogous otherwise than technically to a partnership . . . . there seems to be no greater objection to restraining the right of choosing one's associates in a corporation than in a firm." [9] The restriction involved in the principal case, its purpose being to control the personnel of the corporation, should not be deemed a prohibition against the alienation of stock, but rather should be characterized as a recognition of the shareholder's right to transfer his shares, coupled with the restriction that if the shareholder wishes to transfer them, he should first offer them to the corporation.[10] While a few courts have held such a restriction to be invalid, the weight of authority has recognized that such options inserted in the charter or by-laws [11] giving the corporation the first refusal are reasonable and legitimate.[12] The significance of the decision in the principal case is that it tends to remove the dubious implications sometimes expressed that such a restriction may not be effective as against pledgees.[13] Yet, if the draughtsman of the articles or by-laws has adequately performed his function, should not the question of whether the subsequent transferee is a vendee or pledgee be immaterial? [14]

John F. O'Connor, S.Ed.

[8] For example, see the restriction struck down in Greene v. E. H. Rollins & Sons, Inc., 22 Del. Ch. 394, 2 A. (2d) 249 (1938).

[9] Barrett v. King, 181 Mass. 476 at 479, 63 N.E. 934 (1902). Of course Holmes was talking about small corporations.

[10] STEVENS, PRIVATE CORPORATIONS 505 (1936).

[11] It is said "that in absence of legislation . . . . a mere by-law is deemed insufficient to create a valid restriction, although if reasonable, such a by-law generally will be given effect as a contract among the assenting stockholders." See 42 HARV. L. REV. 555 at 557 (1929), and cases cited therein.

[12] BALLANTINE, CORPORATIONS 779 (1946). But the corporation must have the power to purchase its own stock. State v. Olympia Veneer Co., 138 Wash. 144, 244 P. 261 (1926). The Uniform Stock Transfer Act, § 15 provides that there shall be no restriction upon the transfer of shares unless the restriction is stated on the certificate.

[13] See CHRISTY, THE TRANSFER OF STOCK, 2d ed., 78 (1940). An examination of the cases cited in Christy will reveal that they can be explained either by the fact that the restriction was not printed on the cerificate or that the provision did not *specifically* cover pledges—the courts construing the provision narrowly. The cases cited in Christy involving this point and involuntary transfers are: People ex rel. Malcolm v. Lake Sand Corporation, 251 Ill. App. 499 (1929); Magnetic Mfg. Co. v. Manegold, 201 Wis. 154, 229 N.W. 544 (1930); Silversmiths Co. v. Reed and Barton Corp., 199 Mass. 371, 85 N.E. 433 (1908); Good Fellows Associates, Inc. v. Silverman, 283 Mass. 173, 186 N.E. 48 (1933); Crescent City Seltz and Mineral Water Mfg. Co. v. Deblieux, 40 La. Ann. 155, 3 S. 726 (1888); Barrows v. The National Rubber Company, 12 R.I. 173 (1878); Lane v. Albertson, 78 App. Div. 607, 79 N.Y.S. 947 (1903).

[14] As such a provision is usually narrowly construed it would seem that the course of wisdom in draughting would lie in being as explicit as possible.