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Share Transfer Restrictions in Close Corporations as Mechanisms for Intelligible Corporate Outcomes

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SHARE TRANSFER RESTRICTIONS IN CLOSE CORPORATIONS AS MECHANISMS FOR INTELLIGIBLE CORPORATE OUTCOMES

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I. INTRODUCTION[1]

"[T]he most likely purpose for share transfer restrictions in close corporations is to prevent *outsiders* from purchasing shares and potentially damaging the company."[2]

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[1] *See* 12 WILLIAM MEADE FLETCHER ET. AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5453 (2011) ("Both publicly held and closely held corporations *may* place share transfer restrictions in the articles of incorporation, bylaws, or agreements among shareholders or between the shareholders and the corporation.") (emphasis added) (citations omitted). This article, however, discusses share transfer restrictions in the context of close corporations. Discussion and coverage in this article are restricted to share transfer restrictions in close corporations because share transfer restrictions that are binding upon stockholders in publicly held corporations are arguably incompatible with commercial expectations relating to publicly held stock and are, therefore, not the norm. This is the case because the inclusion of share transfer restrictions in the articles or bylaws of publicly held corporations is not a widespread commercial practice. Realistically, public stock exchanges would, in all likelihood, be unwilling to list corporations with such restrictions for public trading.

[2] Maurer v. Haines City Mobile Park & Sales, Inc., No. WD-00-051, 2002 WL 479771, at *4 (Ohio Ct. App. March 29, 2002) (emphasis added). Share transfer restrictions in corporate bylaws are also very effective in terminating conflicts between *insiders* as well. *See* Moses v. Soule, 63 Misc. 203, 209 (N.Y. Sup. Ct. 1909) ("In the management of corporations few things are more apparent than the desire to keep the control of the same in the hands of people who are congenial to the enterprise and to those who manage its affairs. A quarreling directorate is a misfortune to the stockholders of any corporation. When such situations occur, as they often do, there is no objection to the purchase by the corporation of the shares of the disgruntled stockholders and the resale of the stock to

Analysis, evaluation, and synthesis of legally valid share transfer restrictions[3] in the corporate documents[4] of close corpora-

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those more in harmony with the enterprise. In the organization of corporations it is frequently provided in the articles or by-laws that a stockholder shall not sell his stock *without first giving a stated period within which the corporation and the other stockholders may have opportunity to purchase. I find nothing in all this against public policy. On the contrary, it has to do solely with common sense and practical business.") (emphasis added). See also Lawson v. Household Finance Corp., 147 A. 312, 315 (Del. Ch. 1929) ("[I]n the power of regulation [of a corporation] may be included the obligation of first offering the stock to the corporation or to the then stockholders.... [P]ublic policy is not offended by such a provision ... where the restraint was imposed by charter provisions. But even where ... the subject is undertaken to be dealt with in by-laws ... the restraint is nevertheless a valid one.") (emphasis added) (citations omitted)(internal quotation marks omitted). See also* FARHAD AGHDAMI, MARY ANN MANCINI, *STRUCTURING BUY-SELL AGREEMENTS: ANALYSIS WITH FORMS CURRENT THROUGH 2011 ¶ 7.04 *1: Restrictions on Voluntary Transfers. ("The fundamental purpose of most buy-sell agreements is to prevent the sale by existing business owners of their interests in the company to persons outside the original control group.").*

[3] Maurer v. Haines City Mobile Park & Sales, Inc., 2002 WL 479771, at *4 ("The validity of a share transfer restriction is governed by the law of the state of incorporation.").

[4] In the U.S., there is essentially no federal incorporation of business corporations. Therefore, each business corporation is incorporated under the statutory laws of one of the individual fifty states. Typically, "[o]ne or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing." MODEL BUS. CORP. ACT § 2.01 (1984) (revised and amended through to 2010). *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: STATUTES, RULES, MATERIALS, AND FORMS, 697 (2010) [hereinafter MBCA]. "The Revised Model Business Corporation Act (1984) is designed to be a convenient guide for revision of state business corporation statutes, reflecting current views as to the appropriate accommodation of the various commercial and social interests involved in modern business corporations. This Act is designed for use by both publicly held and closely held corporations ..." MODEL BUS. CORP. ACT ANNOTATED, introductory cmt. at xxvii (3rd ed. 1994). *See also* ROBERT W. HAMILTON, STATUTORY SUPPLEMENT TO CASES AND MATERIALS ON CORPORATIONS: INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 118 (6th ed. 1998) [hereinafter HAMILTON: STATUTORY SUPP. 1998] ("[The MBCA] was prepared and is maintained by the Committee on Corporate Laws of the Section on Business Law of the American Bar Association. Earlier versions ... were influential in the development of state corporation statutes[,] ... were used by more than 30 states as a model in the recodification of their business corporation statutes, and had noticeable but less significant influence in a number of other states. The 1984 Model Business Corporation Act is a complete revision of earlier [versions,] ... was approved by the Committee on Corporate Laws [as] the "Revised Model Business Corporation Act (1984)" and was renamed the "Model Business Corporation Act (1984)" in 1987. It has been used as the model for corporation statutes in 22 states ..."). *See also* ROBERT W. HAMILTON, STATUTORY SUPPLEMENT TO CASES AND MATERIALS ON CORPORATIONS: INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 94 (7th ed. 2001) [hereinafter HAMILTON: STATUTORY SUPP. 2001] ("The [MBCA] is a free-standing general corporation statute that can be enacted substantially in its entirety by a state legislature.").

tions[5] are intriguing. Actually, share transfer restrictions[6] tend to be included within a corporation's bylaws,[7] rather than in its articles of incorporation.[8] Nevertheless, subject to any statutory preconditions,[9] the legal validity of such restrictions is transcendent whether located in one or both[10] of these two corporate documents.[11]

Corporate share transfer restrictions are often drafted as rights of first refusal granted to the corporation, to the current shareholders, or to both. Therefore, drafting ingenuity, creativity, and, above all clarity, are at a premium.[12] Moreover, the most significant substantive legal basis for enforcement of share transfer restrictions is contractual.[13]

However, the location of any share transfer restriction in controversy is not legally significant. Share transfer restrictions located in corporate bylaws or elsewhere are binding on the stockholders of the corporation based upon orthodox contract principles.[14] This binding contractual effect is legally indistinguishable from agreements between shareholders, which do not become a bylaw of the corporation. The fundamentally binding contractual

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[5] In this article the terms "corporation" and "company," as well as "shareholder" and "stockholder," will be treated as synonyms and will be used interchangeably.

[6] *Also referred to as* "buy-sell" agreements. *See* AGHDAMI, MANCINI & ZARITSKY, *supra* note 2 at ¶ 7.04.

[7] *See* MBCA §§2.05, 2.06. A business corporation typically adopts its bylaws at its organizational meeting under the MBCA.

[8] *Lawson*, 147 A. at 315.

[9] *See, e.g.*, Harlamert v. World Finer Foods, Inc., 489 F.3d 767, 772 (6th Cir. 2007) ("Pursuant to Delaware statute ... a written restriction on the transfer of a security of a corporation, noted conspicuously on the certificate, *may* be enforced against the holder of the restricted security or any successor or transferee of the holder including an estate administrator .... Unless noted conspicuously on the certificate, a restriction "is ineffective *except* against a person with *actual knowledge of the restriction*.") (emphasis added) (citations omitted). A large number of corporations are incorporated under Delaware statute and the referenced Delaware specific statutory provisions are typically present in the corporate statutes of a majority of states.

[10] *See infra* note 29.

[11] *Lawson*, 147 A. at 315.

[12] *See infra* Part V.

[13] *See infra* Part IV.

[14] Rychwalski v. Milwaukee Candy Co., 236 N.W. 131, 132 (Wis. 1931) ("These restrictions are sustained as a contract existing between the stockholders."). *See supra* note 13. They are also a contract between the shareholders and the corporation. *See infra* note 18.

effect is essentially equivalent in legal impact and outcome.[15] Such agreements between the shareholders of a corporation may often require 100% of the shareholders of the particular corporation to be signatories to each pertinent agreement. Thus, notwithstanding the fact that the provisions of such agreements might *not* become an actual bylaw of the pertinent corporation in which the shares are held, nevertheless, the applicable legal principles coincide. The contractually restrictive effect is legally valid whether the provision in controversy is in a bylaw, in a buy-sell agreement between the shareholders, in the articles of the corporation, or elsewhere.

In order to be treated by the courts as legally valid, share transfer restrictions must be judicially determined to be reasonable.[16] Share transfer restrictions are subject to the entire array of ordinary contract law principles.[17] It must therefore be proven that each party allegedly bound by a particular share transfer restriction is contractually a party to the agreement which embodies the critical terms of the applicable share transfer restriction.[18]

Thus, the rights conferred by valid share transfer restrictions upon the recipients of such rights are subject to contract

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[15] *See* Shields v. Shields, 498 A.2d 161, 168 (1985) ("Agreements between stockholders with respect to their stock ... take any number of forms.") (citation omitted).

[16] *See infra* Part VI. *See also* 15A AM. JUR. 2D *Commercial* § 87 ("Provided a restraint on alienation of stock effectuates a *lawful purpose*, is *reasonable*, and is *in accord with public policy*, it is *enforceable*.") (emphasis added) (citation omitted). *See also* FLETCHER, *supra* note 1 at § 5455. *See also* Witte v. Beverly Lakes Inv. Co., 715 S.W.2d 286, 291 (Mo. Ct. App. 1986) ("I]t developed that a share of stock is neither, strictly, personal property nor a contract chose, but *sui generis*, with free transferability as the essential attribute. It is not a matter of property merely, because alienation may be restrained. It is not a matter of contract merely, because although agreement may restrict transfer, an absolute restriction on transfer is unreasonable per se and void. It is on the rationale that the essential attribute of a share of stock remains its transferability that only those restrictions on alienation, both *reasonable* and in good faith, are valid and enforceable.") (emphasis added) (citations omitted).

[17] *Id.*

[18] *See, e.g.*, *Harlamert*, 489 F.3d at 772. With respect to the statutory provisions identified in the citation ("However, '[n]o restrictions so imposed shall be binding with respect to securities issued *prior* to the adoption of the restriction unless the holders of the securities *are parties to an agreement or voted in favor of the restriction*.") (alteration in original) (emphasis added) (citation omitted). *See also* FLETCHER, *supra* note 1 at § 5453. *See also* Boston Safe Deposit & Trust Co. v. North Attleborough Chapter of Am. Red Cross, 111 N.E.2d 447, 449 (Mass. 1953) ("[Corporate share transfer restrictions are binding] *by reason of the contract made with the corporation* when [a shareholder] accepted the certificates of stock containing the printed restrictions.") (emphasis added) (citation omitted).

law fundamentals such as waiver and estoppel principles.[19] For example, if a stock transfer restriction empowers a corporation to redeem the shares of any deceased shareholder, the corporation must strictly adhere to all specific time constraints included in the agreement.[20] Therefore, failure by the corporation to completely honor the express time constraints required for the valid exercise of its rights will have legal consequences. This failure can be legally fatal to retention of those rights by the corporation. It can legally nullify them. Therefore, in appropriate circumstances, a corporation[21] may substantively forfeit such rights based upon valid proof that the corporation waived them.[22] Each controversy depends upon the facts and circumstances of the specific case.[23]

Of course, subject to a finite number of specific conditions precedent,[24] corporate bylaws that explicitly but reasonably restrict share transfers tend to be judicially interpreted as legally valid.[25] Moreover, the sentiments expressed by one commentator[26]- in the context of conflicts of interest *within* the firm – also resonate harmoniously with the quest to resolve conflicts addressed by share transfer restrictions in close corporations.[27]

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[19] *See infra* Part V. B and accompanying text discussing waiver and estoppel.

[20] *See Harlamert*, 489 F.3d at 771 ("Contrary to the thirty-day redemption provision in the shareholder agreement, [the corporation] did not attempt to redeem [the deceased shareholder]'s shares until ... more than 100 days after [the shareholder]'s death ....").

[21] Or any other party to any valid share transfer restriction.

[22] *See Harlamert*, 489 F.3d at 775 ("Because [the corporation] failed to redeem [the deceased shareholder]'s shares within thirty days of his death, [the court] find[s] that [the corporation] *waived its right to redeem* those shares.") (emphasis added).

[23] *Id.*

[24] *See* Roach v. Bynum, 403 So.2d 187, 191 (Ala. 1981) ("As a general rule, bylaws of a corporation are valid if they are *reasonable, proper objects of the corporation,* and are *consistent with the charter* and *statutory law* governing the corporation.") (emphasis added) (citations omitted).

[25] *Id. See also supra* note 16; JAMES D. COX & THOMAS L. HAZEN, BUSINESS ORGANIZATIONS LAW, 1 (3rd ed. 2011) ("In a closely held business, however, in which each shareholder is an active, vital member of the management team and the active participants do not look to outside investors for funds, *free transferability of shares may be undesirable*.") (emphasis added) (citation omitted).

[26] *See* Jonathan Macey, *The Nature of Conflicts of Interest Within the Firm*, 31 J. CORP. L. 613, 619 (2006) ("Regardless of the complexity of the contractual arrangements that characterize the people and firms that have contractual relations with a company, the same basic point remains: conflicts among these various classes of claimants about strategy and tactics are ubiquitous. *Contracts are necessary to address these conflicts*." (emphasis added)).

[27] *See supra* note 2.

In some instances, the retention of a particular legal status[28] by a close corporation may also depend upon the enforcement of share transfer restrictions in its corporate bylaws.[29] Furthermore, where the share transfer restrictions have been included in the corporation's bylaws expressly or impliedly for the *corporation*'s benefit, the corporation itself can waive the pertinent share transfer restrictions.[30]

However, disputes that arise under share transfer restriction agreements cannot be mandatorily resolved by arbitration *per se*. On the contrary, unless a valid express agreement has restricted the resolution of such disputes to arbitration as the dispositive legal mechanism,[31] orthodox court resolution of these disputes is the norm.

This article examines judicial approaches to the interpretation and enforcement of share transfer restrictions in close corporations in the dynamic context of individual fact controversies. The article discusses and determines whether or not share transfer restrictions in close corporations have genuinely assisted the courts, the corporate community, and business society on the whole in reaching intelligible corporate outcomes.

The introduction in Part I sets the stage for analysis of these restrictions, which may also be referred to as buy-sell agreements. Part II provides a relatively brief historical perspective of share transfer restrictions and traces the evolution of judicial approaches to them. This section explores how this evolution in judicial thinking developed concomitantly with judicial assessment of the impact of the emerging power of corporations on societal development. Part III analyzes the objectives of share transfer restrictions and provides the transition to the substance of Part IV.

Part IV explains the contractual basis enunciated by the courts as the substantive instrument for enforcement of share trans-

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[28] *E.g.*, retention of Subchapter S corporate status.

[29] *Id.*

[30] Dolan v. Airpark, Inc., 24 Mass. App. Ct. 978, 979 (1987) ("[Share transfer] restrictions can be waived by the corporation, [when] they are for its benefit.") (citations omitted).

[31] Wang v. Biogen Idec, Inc., No. 051562, 2006 WL 933381 *3 (Mass. Super. Mar. 21, 2006) ("[Where] the parties have not contracted to arbitrate any disputes that arise under the Share Restriction Agreement ... [the] Court will not read such a clause into the agreement.").

fer restrictions. This serves as the connection to Part V, which analyzes the drafting challenges faced by those who make use of share transfer restrictions as mechanisms to reach chosen corporate objectives. Part V discusses some of the significant hurdles that drafters have to surmount in order to attain these selected goals. This section also identifies the preferred remedy sought from the courts in order to achieve specific enforcement of the terms agreed upon in the particular share transfer restrictions. Additionally, it analyzes the prospects of success in persuading the courts to grant the preferred remedy.

Part VI interprets more fully the right of alienation. Next, it analyzes and discusses the unavoidable legal impact on share transfer restrictions of conceptions of reasonableness. Then, it explains that conceptions of reasonableness determine whether or not the court will enforce each share transfer restriction in controversy.

Part VII analyzes the substantive characteristics of share transfer restrictions as the courts construe them in the specific cases selected for examination. Additionally, it evaluates and synthesizes the judiciary's interpretation of these restrictions in determining whether the particular restriction in issue meets the challenge of judicial scrutiny. It also explains the foundation of applicable legal criteria developed by the courts as lenses through which to conduct this judicial scrutiny. Distinguishing voluntary transfers from involuntary ones is used to assist in the task of understanding the judiciary's enforcement philosophy in action. The conclusion in Part VIII closes the discussion with the observation that clearly and unambiguously drafted share transfer restrictions have been for the most part quite effective in meeting the drafters' and business community's goals. It also observes that corporate law experience relating to the use of such restrictions has successfully allayed judicial and societal concerns as well.

II. HISTORICAL PERSPECTIVE

A very brief historical perspective relating to corporations generally,[32] and to share transfer restrictions in close corporations

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[32] *See, e.g.*, William H. Fain, *Limitations of the Statutory Power of Majority Stockholders to Dissolve a Corporation*, 25 HARV L. REV.. 677, 680 (1912) ("The tendency of human affairs to become complicated [is] by no means diminished *when the interests of many converge*, as in the case of an enterprise conducted by a stock corporation ....") (empha-

in particular, generates dividends. It provides a more complete picture of the progressive development of the law in this context. It also highlights pivotal turning points in their legal evolution. It explores the continuum of the development of judicial approaches to share transfer restrictions over time. It also shows that, based upon analysis and reflection, the judiciary has proceeded from reluctance or even hostility to enforcement of such restrictions on the alienation of property rights in general to a more rational approach. This approach involves a factual and contextual determination by the courts of the reasonableness of each specific restriction.[33]

Applying this approach over time, courts have concluded that proof of full and complete compliance with the standards that they have developed earns enforcement of the particular share transfer restriction in controversy. This outcome is sensible. It is valid because it is intelligible in light of its fundamental grounding in fair and equitable principles.

Share transfer restrictions are not valid *per se*. The judicial philosophy relating to assessment of the validity of share transfer restrictions developed along a spectrum. The conferral of legal validity *per se* was *not* the starting point of the common law's inquiry. Nor is it the current law. The development of viable standards applicable to share transfer restrictions was thought through by the courts along a continuum of incubation and reflection. As a result, judicial enforcement represents the arrival at a particular destination after an incrementally crafted intellectual quest. This destination has been the conferral of legal validity where appropriate as the final resolution of each case.

However, this judicial cerebral journey of development started much earlier. It started in an era when rapidly developing corporate commercial power was feared.[34] In that era, actions tak-

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sis added). This insightful observation remains true with regard to human business activity today.

[33] *See supra* note 12.

[34] For an example of Federal legislative action that was taken to assist in addressing these fears. *See e.g.* Spanish Broadcasting System of Fla., Inc. v. Clear Channel Communications, Inc., 376 F.3d 1065, 1069 (11th Cir. 2004) ("Congress passed the ... first major piece of antitrust legislation, in 1890 [because,] [f]ollowing the Civil War, rapid industrialization under relatively limited governmental regulation allowed *large firms* and coordinated groups in several industries to *amass considerable economic power* at the expense of smaller rivals. Congress sought to restore a competitive environment and limit

en by corporations were viewed with judicial suspicion and perhaps apprehension. Corporate behavior was suspect. Therefore, this historical perspective traces the transition in corporate law from first - an opposition to legal validity to ultimately, judicial enforcement of share transfer restrictions where legally appropriate.[35] It also traces the motivation for the development of judicial standards along this time continuum.

At common law, initially, courts ruled that the placement by corporations of restrictions on the free and unfettered alienation of corporate shares of stock[36] was null and void.[37] The common law view was that corporate shares were simply a species of property rights.[38] As a result, historically, share transfer restrictions were treated as legally intolerable restraints on these statutorily created property rights.[39] Such restrictions were perceived as legally inappropriate shackles on the dignity of such property rights.[40] Orthodox common law fundamentals applicable to property rights generally - therefore mandated the application of such legal and equitable principles to share transfer restrictions as well.[41]

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the formation, persistence, and power of large, anticompetitive combinations." (emphasis added) (citation omitted)).

[35] *See supra* note 16.

[36] A *statutorily authorized restriction* would, of course, be enforced by the courts. *See, e.g.*, 61 A.L.R.2d 1318 §7 ("[W]here a statute authorized the prohibition of transfers [as specified] ... [t]he court said that in enacting the statute, the legislature 'declared the public policy of the state as favoring such restrictions,' and that the restriction was 'not unreasonable, in view of the [facts] ....' The court therefore held the restriction valid since it was included in *both* the *articles* and *bylaws* of that specific business association. Statutorily authorized provisions implicate separation of powers issues. *See. e.g.*, Lichter v. United States, 334 U.S. 742, 779 (1948) ("[I]t is essential that ... the respective branches of the government keep within the powers assigned to each by the Constitution.").

[37] *See, e.g.*, Witte v. Beverly Lakes Inv. Co., 715 S.W.2d 286, 290 (Mo. Ct. App. 1986) ("It was the orthodoxy at common law that a share of stock was personal property and, like all others of that species, was freely transferable. Thus, restraints on alienation were, on principle, repugnant to a free economy – and hence *contrary to public policy and void*.") (emphasis added) (citations omitted).

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id. See also* Dobry v. Dobry, 262 P.2d 691, 692 (Okla. 1953) ("Such charter and bylaw provisions designed to prevent the transfer of corporation stock to 'outsiders' ... [were] *declared void*, as being in restraint of trade and contrary to public policy ....") (emphasis added).

The birth of the twentieth century marked a pivotal change in corporate law applicable to share transfer restrictions. This fundamental change was sparked by a fountainhead[42] decision.[43] This decision was a tipping point.[44] It shifted judicial thinking along the axis between legal nullification on the one hand and unequivocal enforcement on the other. A new balance with respect to judicial validation and enforcement of share transfer restrictions needed to be struck. Over time, the decision triggered a fundamental change in judicial attitudes toward the legality of share transfer restrictions altogether.[45]

The decision was Chief Justice Holmes'[46] Supreme Court of Massachusetts opinion in *Barrett v. King*,[47] handed down at the turn of the twentieth century. It operated as a positive force for change.[48] In this transcendent opinion, Chief Justice Holmes repudiated[49] the prior legal sanctum of common law orthodoxy that had

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[42] *See* AYN RAND, THE FOUNTAINHEAD Introduction at v (1943) ("*Longevity* – predominantly, *though not exclusively* – is the prerogative of a literary school ....") (emphasis added). Longevity is also a significant objective of *legal* ideas.

[43] *See* Barrett v. King, 63 N.E. 934, 935 (Mass. 1902).

[44] *See, e.g.*, MALCOLM GLADWELL, THE TIPPING POINT 247 (2000) ("The theory of Tipping Points requires ... that we *reframe the way we think about the world*."). (emphasis added).

[45] *See, e.g.*, F.B.I. Farms, Inc. v. Moore, 798 N.E.2d 440, 445 (Ind. 2003) ("Chief Justice Holmes stated the matter succinctly *a century ago*: '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.' As applied to a family-owned corporation, *this remains valid today*.") (emphasis added) (citations omitted).

[46] Shortly after Chief Justice Holmes, then Chief Justice of the Supreme Judicial Court of Massachusetts, authored his opinion in *Barrett v. King*, 181 Mass. 476 (1902) in May 1902, President Theodore Roosevelt appointed him to the Supreme Court of the United States. The Senate immediately confirmed Justice Holmes' appointment unanimously. *See* On this Day, March 6, 1935, Obituary, Washington Holds Bright Memories of Justice Holmes's Long and Useful Life, NY TIMES, http://www.nytimes.com/learning/general/onthisday/bday/0308.html (last visited July 20, 2011). *See generally* John A. Garraty, *Holmes' Appointment to the Supreme Court*, THE NEW ENG. Q., Sept. 3, 1949, at 291.

[47] *Barrett*, 63 N.E. at 935.

[48] *See Witte*, 715 S.W.2d at 290 ("That traditional analysis, that a share of stock is personal property *merely*, was repudiated by Justice Holmes in the *influential* opinion, *Barrett v. King* ....") (emphasis added) (citation omitted). *See also* Irwin v. West End Development Co., 342 F Supp 687, 696 (D Colo 1972).

[49] Justice Holmes' intellectual boldness and lack of hesitation to chart what he determined to be the right legal course is historically documented. So also is his personal courage. He was wounded on three occasions when he fought -- in his twenties -- as a soldier, with the Union troops during the American Civil War. He returned to duty after

successfully nullified the validity of restrictions on the transfer of corporate stock.[50] In his opinion, Chief Justice Holmes concluded that it was more appropriate to emulate the partnership model as the business blueprint for small corporations in this context.[51]

Chief Justice Holmes seemed more convinced that small corporations differed from large corporations. In his view, the preeminence of the interplay of personal relationships in the internal operation of general or ordinary partnerships was a more valid business paradigm.[52] It is not surprising that Chief Justice Holmes would select the partnership as a viable model to emulate in this regard.[53] American society's business experience[54] with the operation of partnerships provided an alternative approach to the common law nullification orthodoxy applicable to share transfer restrictions at this point in legal history. Chief Justice Holmes's interpretation of the wisdom of this experience impelled him to take a different legal path.[55] Over a century later, that different legal

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he recovered from, first, a serious bullet wound to his chest, and second, a critical bullet wound to his neck. However, he retired after the lengthy period that his third wound, a bullet wound to his tendons that lodged in his heel, took to heal. *See* Obituary, *supra* note 46. *See also* Dean David M. Schizer, *Great Societies Look to the Future,* at p.4, Columbia Law School Graduation Address on May 16, 2011 ("Justice Holmes, who was severely wounded in battle three times, was haunted for the rest of his life by memories of the war and, as he put it, by the "honor and grief from us who stand almost alone, and have seen the best and noblest of our generation pass away.").

[50] *See Barrett,* 63 N.E. at 935 ("Stock in a corporation is *not merely* property. It also creates a personal relation analogous ... 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.*") (emphasis added) (citations omitted).

[51] *Id.*

[52] *Id.*

[53] *See, e.g.*, Robert W. Hillman, *Law, Culture, and the Lore of Partnership: Of Entrepreneurs, Accountability, and the Evolving Status of Partners*, 40 WAKE FOREST L. REV. 793, 795 (2005) ("To a *greater extent* than law supporting other forms of business association, *partnership law* is the product of the *common law's extensive experience* in addressing problems arising from *relationships that underlie business ventures.*" (emphasis added)).

[54] *See, e.g.*, OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1 (Little, Brown & Co. 1938) (1881) ("The life of the law has not been logic: it has been experience."). *See also*, ALBERT EINSTEIN, IDEAS AND OPINIONS 271 (Sonja Bargmann trans., 1954). ("[A]ll knowledge of reality starts from experience and ends in it.").

[55] Of course, no one was capable of foreseeing Justice Holmes' incalculable potential to effect positive and enduring legal change in American jurisprudence in the future. One commentator - writing about the reaction of the press and other constituencies to Justice Holmes' selection for a seat on the U.S. Supreme Court - has expressed the view that, in an appropriate context, Justice Holmes was not substantively irrefutably opposed to *some* restrictions on property rights and therefore viewed appropriate restrictions on property

path imagined and applied by Chief Justice Holmes in *Barrett v. King*[56] continues to be followed.[57]

Chief Justice Holmes must have perceived that essentially, small corporations seemed to be becoming more 'user-friendly' to evolving American business society. These small corporations operated in much the same manner that earlier business organizations such as partnerships had developed.[58] Undoubtedly, the prospect of judicially empowering business participants in small corporations to choose those with whom they would associate as shareholders made sense.[59] Small corporations tended to more closely resemble partnerships in scope as well. Chief Justice Holmes must have concluded that analogizing small corporations to partnerships seemed more commercially appropriate.[60] More particularly, at least one earlier legal parallel[61] in the *legislature's* treatment in analogizing corporations to partnerships[62] must have been familiar to Chief Justice Holmes.

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rights as judicially tolerable. *See* John A. Garraty, *supra* note 46 at 301 ("[Justice Holmes'] conception of the dynamic nature of law, so clearly expressed ... in his great book , *The Common Law*, and his belief that the courts should not interfere with legislative action aimed at social improvement even when property rights were in the process restricted, were practically ignored.").

[56] *Barrett*, 63 N.E. at 936.

[57] *See, e.g., F.B.I. Farms*, 798 N.E.2d at 445.

[58] *See, e.g.*, AMERICAN BAR FOUNDATION, ANALYZING LAW'S REACH 511 (2008) ("The question of the identity of and the distinctions between specific forms of organization – partnership, corporation ... raised the most intricate and significant public legal issues of the time. In many ways, the legal-political status of divergent associational bodies ... was the principal jurisprudential question of the nineteenth century. The early American law of associations was highly differentiated. It often proceeded on a case-by-case basis in which the particular nature of the group's activity determined its own special legal status and powers.").

[59] *See, e.g.*, PETER F. DRUCKER, MANAGEMENT, TASKS, RESPONSIBILITIES, PRACTICES 638 (1974) ("[S]ize, structure, and strategy are closely related. Different sizes require different structures, different policies, different strategies, and different behaviors. *There are right sizes and wrong sizes for different businesses*.") (emphasis added).

[60] *Id.* at 640 ("The small organization can do things the large ones cannot do. Its simplicity and small size should give it fast response, agility, and the ability to focus its resources.").

[61] Later parallels exist as well. *See, e.g.*, Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 515 (1975) (referring – in the context of the facts of the case - to "the fundamental resemblance of the close corporation to the partnership ...."). Discussed in Stephen J. Leacock, *Close Corporations and Private Companies under American and English Law: Protecting Minorities*, 14 LAW. AM. 557 (1983).

[62] *See, e.g.*, Arthur A. Ballantine, *Corporate Personality in Income Taxation*, 34 HARV. L. REV.. 573, 574 (1921) ("Under income tax laws of the Civil War period, corporations

Chief Justice Holmes was right. Certainly, historically,[63] significant concerns[64] had arisen with regard to the inexorable rise in the commercial power of corporations generally[65] and American corporations in particular.[66] However, these concerns were generated by the rapidly developing economic power of *large* corporations[67] rather than small ones.[68] Furthermore, the apparent shift in some business practices from formation of partnerships to the formation of small corporations instead was motivated more intensely by certain commercial advantages. Use of the corporate form provided access to these advantages.[69] Formation of a partnership did not accomplish these outcomes as well as small corporations did.[70]

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were similarly treated [to partnerships]. Corporations as such were not taxed, but their income as received was taxed as part of the income of the individual stockholders.").

[63] *See* COX & HAZEN: BUSINESS ORGANIZATIONS, *supra* note 25, at 1 ("Much of the industrial and commercial development of the nineteenth and twentieth centuries was made possible by the corporate mechanism.").

[64] *See, e.g., Spanish Broadcasting System,* 376 F.3d at 1069. *See also* David McCord Wright, *The Modern Corporation – Twenty Years After*, 19 U. CHI L. REV. 668, 677 (1952) ("The corporation of today, by reason of this change in the courts from an attitude of trust to one at times approaching distrust, can no longer be indifferent to the antitrust laws.").

[65] Some contemporaneous scholarship chronicles this general concern. *See, e.g.*, Inaugural Address delivered Nov. 1, 1901, by Professor Henry Wade Rogers, Professor of Corporations and Equity at Yale University, 11 YALE L. J.., 223, 229 (1902) ("Some years ago [one commentator] stated that private corporations *already owned from one-third to one-half of the capital of the civilized world.*") (emphasis added).

[66] *See id.* ("In 1887 a distinguished authority in economics declared it within the bounds of moderation to estimate the wealth of *corporations in the United States* as one-fourth of *the total value of all property in the country*. He declared that the *rapidly increasing proportion* of all resources of the country belonging to corporations was a *significant* fact.") (emphasis added).

[67] *See id.* ("Another authority ... estimated the wealth of corporations as increasing *three or four times as rapidly* as those of private concerns .... [T]he wealth of corporations has ... enormously increased ... *out of all proportion to any previous period in our history.*") (emphasis added) (citation omitted). For example, with respect to large corporations, legal steps were developed to provide protection – in the public interest - from the unrestrained power of such corporations, by restricting the sphere of their business activities. *See, e.g.*, the development and application of the ultra vires doctrine to corporations, discussed in Stephen J. Leacock, *The Rise and Fall of the Ultra Vires Doctrine in United States, United Kingdom and Commonwealth Caribbean Corporate Common Law: A Triumph of Experience Over Logic*, 5 DEPAUL BUS. & COM. L. J. 67 (2006).

[68] *I.e.* close corporations.

[69] *See* COX & HAZEN, *supra* note 25, at 6.

[70] *Id.*

Formation of a corporation conferred "exemption of shareholders from personal liability"[71] for the *corporation's* debts and obligations.[72] Additionally, in a typical business corporation, each shareholder of the corporation enjoyed limited liability.[73] In contrast, the law applicable to partnerships was different.[74] Indeed, historically, under the law applicable to general or ordinary partnerships, a heavy commercial and financial burden existed.[75]

Partnership formation had the following legal effect. First, each individual was, and still is, of course, subject to unlimited personal liability for his or her own personal obligations. This is a common law norm. Second, on the formation of a valid general or ordinary partnership, an additional incidence of unlimited personal liability attached.[76] This second incidence of unlimited personal liability is as follows: on becoming a partner in such a partnership each partner also becomes subject to unlimited personal liability again. This unlimited personal liability is for the legally binding debts and other legally valid obligations of the *partnership* of which the individual is a member.[77]

These burdensome business standards changed with the advent of later developments in the tax laws applicable to some close corporations.[78] The Federal Legislature has combined the ad-

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[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.* at 7.

[75] *See, e.g.*, HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS 73 (3rd ed. 1983).

[76] *Id.*

[77] This remains the case under the statutorily conferred "entity status" of general or ordinary partnerships which modern state partnership statutes have enacted. *See, e.g.*, Evanston Ins. Co. v. Dillard Dept. Stores, Inc., 602 F.3d 610, 617-618 (5th Cir. 2010) ("Under the entity theory of partnerships, it is logical that a partner has no liability until the partnership liability is established. There is nothing wrong in allowing the partners to be sued along with the partnership so that once the partnership liability is established, a judgment can be rendered against the partnership and the partners. On the other hand, there is nothing wrong with the partnership being sued and, if its liability is established, a subsequent suit being filed against the partners *on their personal liability for the partnership's obligation*.") (citation omitted).

[78] In order to reap these tax benefits, size limits on *eligible* close corporations (*i.e.*, Subchapter S corporations) are statutorily imposed by the Federal legislature. *See* 26 U.S.C.A. § 1361(b)(1)(A) I.R.C. *effective* May 25, 2007 ("(b) Small business corporation.-- (1) In general.--For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not-- (A) have more than 100 shareholders ....").

vantages of corporate formation generally with the *sui generis* tax advantages of general or ordinary partnerships.[79] For over half a century now,[80] with respect to some close corporations, the Federal Legislature has recombined[81] the advantages of limited liability[82] derived from formation of a corporation with the tax advantages derived from forming a general or ordinary partnership.[83] This means that, for shareholders in this type of close corporation, these positive developments have conferred these benefits.

The financial advantages of the avoidance of personal liability, and those of tax-free status enjoyed by the general or ordinary partnership, are therefore symbiotically and synergistically combined. Partnerships as a business organization are not taxed. Rather, the *partners* in a partnership are taxed, not the partnership itself. Partners are subject to pay taxes levied upon the distributions to which the partners are entitled under the terms of the partnership agreement. However, there is no incidence of partnership tax liability on the partnership as a business association.

In summary, these advantages are, therefore, twofold. First, they shield stockholders of close corporations generally from unlimited liability for the close corporation's debts and other valid legal obligations. Second, they confer upon Subchapter S close corporations the same tax advantages that general or ordinary partnerships enjoy.

Unquestionably, in human life, the familiar is less frightening than the unknown. Partnerships were more familiar to the business community and to the judiciary. When compared with partnerships, corporations and their future development represented relatively unknown territory. Moreover, experience with part-

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[79] *Id.*

[80] *See, e.g.*, Larry E. Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751, 768-769 (2005) ("Tax rules may explain the close corporation's survival. Most importantly, Congress has channeled closely held firms into close corporation form through Subchapter S of the IRC, passed in 1958 *to give closely held corporations many of the tax advantages of partnership*.") (emphasis added) (citations omitted).

[81] *See* Ballantine, *supra* note 62 (highlighting similar tax treatment for corporations and partnerships historically during the Civil War period).

[82] *See* Cox & Hazen, *supra* note 69.

[83] Partnerships are *not* subjected to a partnership tax. In a partnership, legal tax obligations fall upon the individual partners who are members of the general or ordinary partnership. Each partner is subject to her, his, or its own individual or entity tax obligations and not the partnership itself.

nership operation in the business universe had historically been unintimidating. In fact, it had been commercially quite wholesome. Therefore, to the extent that close corporations could be analogized to partnerships, all would probably be perceived to remain well in the business sphere.

Interestingly enough, societal attitudes towards corporations have changed in more modern times. Earlier fears relating to the potential power of corporations in general have been progressively subsiding.[84] In the present day context, these developments have reached the point where the historical fear of corporate power has significantly diminished.[85] Today, in American corporate law, under the Model Business Corporations Act, a corporation is free to engage in any business which is legal for any individual to engage in.[86] One commentator has observed that, in modern times, "[e]conomic associations in the form of corporations and partnerships control most American economic activity."[87]

III. OBJECTIVES OF RESTRICTIONS

Share transfer restrictions are extremely important to close corporations.[88] However, corporate law does not confer power on corporations to restrict share transfers absolutely.[89] Corporate share transfer restrictions must be *reasonable*[90] in order to survive legal nullification by the courts.[91] It is undeniable that corporate bylaws which restrict the transfer of stock in close corporations

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[84] Especially any lingering fear of small corporations such as close corporations.

[85] *E.g.*, in American corporate law, the ultra vires doctrine has been almost completely eliminated. *See supra* note 42 at 95 (In American corporate law "a corporation can do every mortal thing that it wants, provided that the activity is lawful for an individual to pursue.") (citation omitted).

[86] *See* MBCA § 3.02.

[87] *See, e.g.*, AMERICAN BAR FOUNDATION, ANALYZING LAW'S REACH, at 494 (2008).

[88] *See, e.g.*, Castonguay v. Castonguay, 306 N.W.2d 143, 145 (Minn. 1981) ("A corporation, as a matter of *business prudence*, may *legitimately* desire to keep its stock in the hands of those who are *congenial and will work together for the success of the enterprise*.") (emphasis added) (citation omitted).

[89] *See Rychwalski*, 236 N.W. at 132 (Wis. Sup. Ct. 1931) ("It is well established ... that a corporate by-law which *prohibits the alienation* of shares of stock ... is void.") (emphasis added).

[90] *See infra* Section V. Right of Alienation and Conceptions of Reasonableness.

[91] *See Rychwalski*, 236 N.W. at 132 ("[A] corporate by-law ... which amounts to an *unreasonable* restraint upon [the] transfer [of stock], is void.") (emphasis added).

perform unique functions. First, they protect and preserve founding corporate shareholders' control over the corporation.[92] Second, they conserve and enhance the commercial integrity of the close corporation by providing an identifiable market for its shares.[93] Third, they assist in procuring certain genuine and identifiable tax advantages.[94]

Of course, close corporations are distinguishable from publicly held companies. The essential attributes of close corporations are characterized by the following: (1) the shareholders are few in number, often as few as two or three; (2) they often live in the same geographical area, may be biologically related, or know each other very well, and are quite well acquainted with each other's business skills; (3) all or most of the shareholders are active in the business, usually serving as directors or officers, or as key participants in some managerial capacity; and (4) there is no established market for the corporate stock, the shares not being listed on a stock exchange or actively dealt in by brokers.[95]

Moreover, shareholders in close corporations, particularly those owned by a single family, may be genuinely concerned about the identity of their business associates.[96] The initial shareholders' motivation to control the identity of future shareholders may also be a function of certain specific factors. These founding shareholders may strive to obviate the entry of disruptive additional shareholders who could abort the harmony and profitability of the business.[97] Permitting membership to incompatible personalities could

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[92] *See supra* note 2. *See also* Roth v. Opiela, 813 N.E.2d 114, 116 (Ill. 2004) ("[T]o promote harmonious management of the Corporation's affairs.").

[93] *See, e.g.*, Stephen J. Leacock, *The Anatomy of Valuing Stock in Closely Held Corporations: Pursuing the Phantom of Objectivity into the New Millennium*, 2001 COLUM. BUS. REV.. 161, 170 (2001).

[94] *See* Groves v. Prickett, 420 F.2d 1119 (9th Cir. 1970), In re Estate of Croonberg, 988 P.2d 41 (Wyo. 1999), Stufft v. Stufft, 916 P.2d 104 (Mont. 1996), Remillong v. Schneider, 185 N.W.2d 493 (N.D. 1971), Tu-Vu Drive-In Corp. v. Ashkins, 391 P.2d 828 (Cal. 1964).

[95] F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATION § 1.08, at 31 (Rev. 3d ed. 2008). *See also* Stephen J. Leacock, *supra* note 93.

[96] *See supra* note 2.

[97] *See, e.g.*, *Rychwalski*, 236 N.W. at 132 ("It is sometimes necessary and often desirable that a corporation protect itself against the acquisition of shares of its stock by *rivals in business, or other disturbers*, who might purchase shares merely for the purpose of acquiring information which might thereafter be used against the interests of the company.") (emphasis added) (citation omitted).

stunt the corporation by sabotaging creation of vibrant management structures.[98] Additionally, the pioneer shareholders may have doubts about an outsider's integrity or business judgment.

Undoubtedly, a competitor foreclosed is competition obviated. Therefore, there may be significant concerns in a close corporation that competitors might try to infiltrate the corporation. Such competitors might try to acquire stock in the corporation and thereby penetrate corporate membership. This could be accomplished by purchasing an interest in the business while driven by that ulterior motive or conceivably other unknown deleterious motives. The competitor's goal could quite easily be the prompt elimination of the competitive risk that another corporation may pose.[99] This would avoid the need for subsequent *elimination* of the particular competition by improved efficiency or increased productivity. These alternatives are more difficult to attain in the business universe.

Yet another factor is the effectiveness of stock transfer restrictions in hindering a single shareholder from gaining absolute control of the corporation by obtaining a majority of the shares. The possibility of gaining majority stock control and the potential risks that it entails should not be overlooked.[100] Share transfer restrictions can be specifically calibrated to address this possibility.

Of course, a restriction requiring a sale to the corporation can provide a considerable benefit for a stockholder or for the estate of a deceased stockholder.[101] This should be borne in mind as well. For, such restrictions assure a measure of liquidity[102] with respect to the overall investment of a shareholder in a close corporation. This is entirely accurate, because stock in close corporations is not readily marketable.[103] If the corporation or other shareholders are actually obligated to purchase the shares owned by a

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[98] *See* O'NEAL & THOMPSON, *supra* note 95, at §§ 1.14, 3.56.

[99] *See id.* at § 3.56.

[100] *See* Crosby v. Beam, 548 N.E.2d 217, 220 (Ohio,1989) ("[T]he close corporation structure also gives majority or controlling shareholders opportunities to oppress minority shareholders. For example, the majority or controlling shareholders may refuse to declare dividends, may grant majority shareholders-officers exorbitant salaries and bonuses, or pay high rent for property leased from the majority shareholders.") (emphasis added) (citation omitted).

[101] *See, e.g.*, Kanawha-Roana Lands, Inc. v. Burford, 359 S.E.2d 618, 621 (W.Va. 1987).

[102] *See* Leacock, *supra* note 93.

[103] *Id.*

deceased shareholder, the estate may be assured that a large, but essentially illiquid asset, will become reasonably marketable.[104]

Finally, stock transfer restrictions may also prevent inadvertent violation of federal and state securities law that could lead to penalties and registration requirements.[105] More particularly, these restrictions can substantially reduce or eliminate unintentional violations of the requirements for retention of subchapter S corporation tax status under the Internal Revenue Code.[106]

IV. CONTRACTUAL BASIS FOR ENFORCEMENT OF CORPORATE SHARE TRANSFER RESTRICTIONS

The corporate documents necessary for valid formation of a corporation must meet the statutory requirements of the pertinent state statute.[107] These corporate documents include articles[108] and bylaws.[109] As indicated earlier,[110] share transfer restrictions which are reasonable[111] may be included in one or both of these two corporate documents. Furthermore, the legal basis for enforcement of corporate share transfer restrictions is contractual.[112] Therefore,

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[104] *See* O'NEAL & THOMPSON, *supra* note 95, at § 3.56.

[105] *See, e.g.*, 15 U.S.C.A. § 77d(2). Restrictions on stock transfers in close corporations can be used as instruments for ensuring that such share transfers properly fit under *exempt transactions*, *i.e.*, "(2) transactions by an issuer not involving any public offering."

[106] *See, e.g.*, 28 U.S.C.A. §§ 1361(b)(1)(A), (b)(1)(B) (West Supp. 2007). *See also* Lindley v. McKnight, 349 S.W.3d 113 (Tex. App. 2011) ("[F]ederal law does *not* require S corporations to have shareholders' [share transfer restrictive] agreements ... however, ... such agreements are helpful to protect Subchapter S status because the agreements may prevent shareholders from exceeding [the statutory maximum number of shareholders] or from transferring stock to an impermissible shareholder ....") (emphasis added). Share transfer restrictions can also alleviate or eliminate warring factions in close corporations. *See, e.g.*, *Moses*, 63 Misc. at 209.

[107] *See, e.g.*, MBCA §2.01-§2.03. and §2.05-§2.06.

[108] *See, e.g.*, *id.* §2.01-§2.03.

[109] *See id.* §2.05-§2.06.

[110] *See supra* note 16.

[111] *See infra* Part VI. Right of Alienation and Conceptions of Reasonableness. *See also supra* note 16.

[112] *See, e.g.*, Alabama Title Loans, Inc. v. White, Nos. 1091642 and 1091677, 2011 WL 2739652, at *6 (Ala. 2011) ("[T]he right of freedom of contract is a cherished one that courts are bound to protect."). *See also Dobry*, 262 P.2d at 692 ("Such charter and bylaw provisions designed to prevent the transfer of corporation stock to 'outsiders' ... have in a *majority of the more recent cases* been upheld as *valid and binding contracts between stockholders*, when the necessary elements are present.") (emphasis added). *See also Rychwalski*, 236 N.W. at 132.

once the corporate documents are properly adopted under the pertinent state statute, they bind the shareholders contractually each to the other.[113] They are also a contract between the shareholders and the corporation.[114] This of necessity means that the shareholders are contractually bound to the corporation as well.[115] So also is the corporation bound to each shareholder.[116] They are all contractually bound each to the other.[117] They must, therefore, all honor the contractual obligations imposed by the corporate documents.[118]

In the context of the case, the Supreme Court of Wisconsin identified and articulated the *contractual* basis of share transfer restrictions in *Rychwalski v. Milwaukee Candy Co.*[119] The substantive legal principles enunciated in *Rychwalski* apply to share transfer restrictions in both corporate articles *and* bylaws.[120] The placement of the provision does not modify the applicable substantive law. On the facts, the Supreme Court of Wisconsin ruled that the articles of incorporation and bylaws of the corporation had been fully complied with in the case.[121] The Court reasoned that the share transfer restrictions at issue precluded *outsiders*[122] from acquiring first priority in purchasing the corporation's stock. Outsiders, rather than current shareholders, were the target of the pertinent share transfer restrictions.[123]

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[113] *Rychwalski*, 236 N.W. at 132 ("These restrictions are sustained as a contract existing between the stockholders.").

[114] *See* Boston Safe Deposit & Trust Co. v. North Attleborough Chapter of American Red Cross, 111 N.E.2d 447, 449 (Mass. 1953) ("[Corporate share transfer restrictions are binding] *by reason of the contract made with the corporation* when [a shareholder] accepted the certificates of stock containing the printed restrictions.") (emphasis added) (citation omitted).

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.*

[119] *Rychwalski,* 236 N.W. at 132 (Wis. 1931) ("[R]estrictions upon the transfer of shares are generally recognized and held valid, where they form part of the charter or articles of organization of the corporation, and are matters of contract between the shareholders.") (citation omitted).

[120] *See id.* ("[R]estrictions upon the alienation of stock as are provided by the *charter and by-laws* in this case are sustained as reasonable provisions ....") (citation omitted).

[121] *Id.* at 133.

[122] *Id* ("The provision for a preference ... obviously relates to a preference as *against outsiders*.") (emphasis added).

[123] *Id.* ("The ... provisions in *the articles* sets out the steps that must be taken *before the stock may be sold to outsiders. The by-laws* provide [no] more than reserve to the re-

As the Court explained, "[i]n this case the sale complained of was not made to an outsider, but to another stockholder . . . ."[124] Since the share transfer restrictions were targeted at outsiders, the pertinent provisions were not at all triggered[125] on the facts in controversy. Any current shareholder would be considered an "insider." Present stockholders would all be ineligible to invoke the share transfer restriction in the first place.

Moreover, the Supreme Court of Oklahoma provided further clarification in *Dobry v. Dobry*.[126] The decision reiterated the judiciary's bedrock view that the legal supremacy of the specific language included in share transfer restrictions remains undisturbed.[127] Courts will not expand the reach of share transfer restrictions beyond the mandated boundaries, which the drafters have linguistically imposed.[128] Therefore, the *Dobry* court explained that the provisions in controversy "[did] not apply to a sale of the corporation's assets . . . ."[129] Extending the restrictions in the pertinent share transfer provisions to include a sale of the corporation's assets would have been an impermissible judicial enlargement of the area of application. The contours of application were clearly delineated by the drafted language of the provisions.[130] The courts ensured that the drafted limits of application were respected.

V. DRAFTING CHALLENGES

A. The Setting

Corporate shares are a species of property. Moreover, as explained in the historical perspective above, courts initially treated share transfer restrictions in bylaws[131] as legally invalid[132] under

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maining stockholders a *preference* in the purchase of shares *over outsiders*.") (emphasis added).

[124] *Id.*

[125] *See infra* note 161. There must be a trigger and it must be pulled.

[126] Dobry v. Dobry, 262 P.2d 691 (Okla. 1953).

[127] *See id.* at 692 ("[Courts take] cognizance of the rule previously laid down in other jurisdictions that such stock sale or transfer restrictions must be 'strictly construed, and not enlarged by implication.'") (citation omitted).

[128] *Id.*

[129] *See id.* at 693.

[130] *Id.*

[131] Legal invalidity arguably remains the law if the prohibition on transfer is in a *bylaw* and is *absolute*. *See, e.g.*, 61 A.L.R.2d 1318 § 3 ("It appears to be the rule that in the

the common law.[133] Despite this initial doctrine, however, over time judicial philosophy with respect to share transfer restrictions changed.[134] On principle, courts now treat restrictions on the transfer of corporate stock as valid where appropriate.[135] This transformation is based upon the judicial transition discussed in the historical perspective. The transition has proceeded from nullification as a legally impermissible restraint on the alienation of property to one of conferral of validity by the judiciary cautiously and discreetly.[136]

The product of this judicial caution and discretion has been disfavored[137] as a judicial starting point. Superseding this disfavor requires proof that the particular share transfer restriction is legally reasonable as defined by the courts.[138] The actual terms of share transfer restrictions matter. This is the case because courts view share transfer restrictions with circumspection and strictly construe them.[139] As a consequence of this legal approach, courts apply the following legal principles identified, analyzed, and discussed below.

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absence of statute a corporate *bylaw* prohibiting the alienation of the stock of the corporation is void as a bylaw.") (emphasis added) (citation omitted).

[132] An absolute prohibition in the articles of a corporation may be a different matter. *See, e.g.*, 61 A.L.R.2d 1318 §7 ("There appear to have been no American decisions on the question of the validity, in the absence of statutory authority, of *absolute prohibitions of the alienation or transfer of corporate stock*, contained *in articles of incorporation* [alone] ....") (emphasis added).

[133] *See, e.g., F.B.I. Farms*, 798 N.E.2d at 445 ("Corporate shares are personal property. At common law, any restriction on the power to alienate personal property *was* impermissible.") (emphasis added) (citations omitted).

[134] *See id.* ("Despite this doctrine, Indiana, like virtually all jurisdictions, allows corporations and their shareholders to impose restrictions on transfers of shares.") (emphasis added) (citations omitted). *See also* In re Estate of Penzenik v. Penz Products, Inc., 800 N.E.2d 1007, 1011 (Ind. Ct. App. 2003), Vogel v. Melish, 203 N.E.2d 411, 413 (Ill. 1964), Taylor's Adm'r v. Taylor, 301 S.W.2d 579, 584 (Ky. 1957).

[135] *Id.*

[136] *Id.*

[137] *See, e.g.*, Burcham v. Unison Bancorp., Inc., 77 P.3d 130, 140 (Kan. 2003) ("This court previously recognized the validity of stockholders' agreements, but stated that restrictions on transfer *are looked upon with disfavor* ....") (emphasis added).

[138] *See, e.g.*, AM. JUR. 2d, CORPORATIONS § 572 (May 2011).

[139] *See, e.g., Burcham*, 77 P.3d at 140 ("[R]estrictions on transfer ... are to be *strictly construed*.") (emphasis added).

1. Drafting

Drafting of a restriction is quintessential.[140] A thorough and complete legal autopsy of the Virginia Supreme Court's decision in *Dominick v. Vassar*[141]supports this assertion. In *Dominick*, the Virginia Supreme Court concluded that the stock option purchase agreement in issue was clearly and unambiguously drafted.[142] The Court therefore specifically enforced it.[143] The specifics of the case are instructive. In *Dominick*, the two sole shareholders of a close corporation entered into a carefully drafted stock transfer restriction agreement. The agreement selected an option as the vehicle to accomplish the goals of the two shareholders.

Under the terms of the option agreement, the parties expressly specified that the death of *either* of the two parties to the pertinent stock option purchase agreement legally *activated* the specified option in the survivor.[144] Furthermore, the step by step details required for the valid exercise of the option were also clearly and unambiguously drafted as express terms of the agreement.[145]

Under these express terms of the agreement, the option could be validly exercised by the surviving shareholder, within ninety days after the demise of either stockholder. Moreover, exercise of the option to purchase the shares of the decedent stockholder was explicitly made binding on certain additional parties. In addition to the two signatory stockholders, the option was expressly made binding upon "the heirs, devisees, assigns, or estate of [the] deceased party . . . ."[146]

These express terms were all-encompassing. Irrefutably, under these carefully crafted terms, exercise of the option explicitly superseded all rights arising subsequent to the decedent shareholder's death.[147] Therefore, if the shares to which the option applied were bequeathed by the decedent's will, the terms of the decedent's will would be superseded by the legally valid exercise of

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[140] *See* FLETCHER, *supra* note 1 at § 5455 ("Share transfer restrictions must be specific and the relative rights of the parties must be clear.") (citation omitted).

[141] Dominick v. Vassar, 367 S.E.2d 487 (Va. 1988).

[142] *Id.* at 490 ("The agreement is clear and valid.").

[143] *Id.*

[144] *Id.* at 488.

[145] *Id.*

[146] *Id.*

[147] *Dominick*, 367 S.E.2d at 488.

the option by the surviving stockholder. This also meant that, on the legally valid exercise of the option, the surviving stockholder would immediately become the owner, in equity, of the decedent shareholder's shares.[148]

Concomitantly, if the surviving stockholder validly exercised the option, the purported recipient of the decedent stockholder's shares, under the provisions of the will, would *not* be entitled to the shares at all. The shares themselves would not be inherited by the beneficiary. Instead, the designated recipient of the shares as the beneficiary of the will would be entitled to the *proceeds* of the shares. These proceeds could be inherited. Under the doctrine of equitable conversion,[149] equitable title to the *shares* would have vested in the surviving stockholder immediately upon the valid exercise of the option. The Virginia Supreme Court ruled that based upon the facts and circumstances of the case, the survivor *had* validly exercised the option.[150] Therefore, the Virginia Supreme Court also ruled that the surviving stockholder was fully entitled to the remedy he sought (i.e. specific performance of the option).

In substance, The Virginia Supreme Court ruled that the surviving shareholder correctly sought the equitable remedy of specific performance of the contract.[151] The Virginia Supreme Court acknowledged that "[s]pecific performance is *not* a remedy of right but one that rests within the sound discretion of the *trial* court . . . . However, a court is *not* at liberty to *rewrite* a contract . . . ."[152] Therefore, in light of all the facts and circumstances of the case, the Virginia Supreme Court also held that full and complete enforcement of the option agreement was appropriate.[153] The

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[148] Analogous to the immediate acquisition of equitable title by a purchaser of real estate under a valid contract for the purchase of the pertinent piece of real estate. *See, e.g.*, Dayspring Development, LLC v. City of Little Canada, No. A09-2289, 2010 WL 3306926, at *2 (Minn. Ct. App. 2010) ("Under the doctrine of equitable conversion, once parties have executed a binding contract for the sale of real estate, ... *equitable title vests in the vendee* and the vendor holds only legal title as security for payment of the balance of the purchase price.") (emphasis added) (citation omitted).

[149] Id.

[150] *Dominick*, 367 S.E.2d at 488.

[151] Id.

[152] *Id.* at 489 (emphasis added) (citations omitted).

[153] *Id.* at 490 ("The agreement is clear and valid, and specific performance is the *only* complete and adequate remedy available to [the survivor].") (emphasis added).

Dominick court therefore reversed the decision of the trial court and remanded the case to the trial court for the entry of a decree of specific performance of the contract.

Based upon its assessment of the option, the following was abundantly clear. In *Dominick v. Vassar*, the Virginia Supreme Court concluded that the pertinent stock option purchase agreement was clearly and unambiguously drafted. The court was also convinced that in light of all the facts and circumstances, the optionee was entitled to specific enforcement. The court therefore specifically enforced it.[154]

However, the specific enforcement of the option agreement did not mean that the decedent's will was legally invalid or defective in its entirety. On the contrary, the court acknowledged that the decedent's will was legally valid.[155] Furthermore, the spouse of the decedent was the sole devisee and legatee of the decedent's will.[156] In addition, she had validly probated her decedent husband's will.[157] However, under the terms of the entirely valid option contract, any purported bequest or other transfer of the shares under decedent's will was superseded by the option.[158]

The Virginia Supreme Court therefore "reverse[d] the judgment of the trial court and remand[ed] the [case] for ... entry of a decree consistent with [the] option."[159] This of course meant that, on remand, any purported bequest or other transfer of the shares could, inevitably, legally, and equitably apply *only* to the *proceeds* of the shares. Once the option was validly exercised, the provisions of the will could not validly apply to the shares themselves.

Moreover, a convincing argument can be successfully made that the courts will specifically enforce a similarly valid and unambiguously drafted corporate bylaw. Imaginative and unambiguous drafting are therefore paramount. In substance, the pertinent terms must confer a clear and irrefutable contractual right on the party seeking enforcement.[160] Of course, the specified right must be ac-

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[154] *Id.*

[155] *Id.* at 488.

[156] *Dominick*, 367 S.E.2d at 488.

[157] *Id.*

[158] *Id.*

[159] *Id.* at 490.

[160] *See* 15A AM. JUR. 2d *Commercial* § 87, *supra* note 16.

tivated by an event that is explicitly identified in the option as well.[161]

As a result of this reasoning, the following legal observation is arguably valid. In the absence of an explicit provision similar to the specifics in *Dominick*,[162] restrictions on the transfer of corporate shares of stock will most likely be held by the courts to apply only to *voluntary* transfers.[163] The stock transfer restrictions would tend to be interpreted by the courts as being applicable to *inter vivos* transfers. This tends to put testamentary transfers, on principle, beyond the reach of share transfer restrictions. This judicially-determined, fundamental principle applies, whether the restriction is contained in articles of incorporation, corporate by-laws, or in a separate written agreement among the shareholders.[164]

Consequently, transfers of shares by operation of law tend to be rationally excluded[165] as well. This is a logical implication of the above reasoning. Therefore, unless expressly included under the specific terms of the share transfer restriction agreement, transfers of shares by operation of law fall outside their ordinary ambit. In light of this legal approach, courts that have considered the question have proceeded with caution and have acted with precision. Such courts have first ascertained whether or not the transfer restriction or shareholders' agreement referred *only* to sales or transfers generally.

Therefore, courts first determine the clear and explicit meaning of the pertinent share transfer restriction. If the judicial conclusion is that the restriction is applicable *only* to sales or transfers generally, then courts have decided as follows. Those courts that have considered the question have been persuaded by the following conception. Conceptually, such restrictions on the transfer

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[161] *I.e.* First, a legally valid option must have a" trigger." However, the "trigger" must be activated in order to validly exercise of the option. *See, e.g.*, Estate of Detwiler v. Offenbecher, 728 F.Supp. 103, 154 (S.D.N.Y. 1989) ("[The] option "trigger" [must] be pulled ....").

[162] *Dominick*, 367 S.E.2d 487.

[163] *See* Rosiny v. Schmidt, 185 A.D.2d 727 (N.Y. App. Div. 1992), *Dominick*, 367 S.E.2d 487, Renberg v. Zarrow, 667 P.2d 465 (Okla. 1983).

[164] *Id.*

[165] *See* Lehtinen v. Drs. Lehtineen, Mervart & West, Inc., 788 N.E.2d 1079 (Ohio 2003), In re Trilling & Montague, 140 F.Supp. 260 (D. Pa. 1956), Elson v. Security State Bank of Allerton, 67 N.W.2d 525 (Iowa 1954).

of corporate stock are *not* applicable to testamentary dispositions at all.

Clearly and explicitly stated *inclusive* terms are necessary in order to snare testamentary dispositions within their ambit. The particular share transfer restriction under judicial scrutiny is subjected to this approach. This conclusion has tended to be based upon the explicit language used in drafting the share transfer restrictions or shareholders' agreements.

Of necessity, the language of the drafted measure exerts ultimate control. Explicit *inclusion* of testamentary disposition within the provisions of the share transfer restriction must be treated by the courts as dispositive. Conceivably, transfers by operation of law *could* also be explicitly included in share transfers restrictions. This means that language in the restriction which expressly or impliedly includes or excludes references to testamentary dispositions will tend to be treated by the judiciary as determinative. The courts, therefore, will tend to treat the omission of express references to transfers by will or other testamentary - or intestate dispositions as pivotal.[166] Such omissions are treated as objectively final. The failure to include applicability to transfers by operation of law would undoubtedly also merit legal parity.

B. Proper Remedy for Enforcement[167]

A question that has not yet been asked, answered, or completely addressed in this article is now ripe for discussion. The question relates to the judiciary's conviction with regard to the proper remedy necessary for successful enforcement of share transfer restriction agreements. This discussion should precede a discussion of the potential conflict arising from the interplay between

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[166] Pennfield Oil Co. v. Winstrom, 720 N.W.2d 886 (Neb. 2006), Kerr v. Porvenir Corp., 889 P.2d 870 (N.M. Ct. App. 1994); Avrett & Ledbetter Roofing & Heating Co. v. Phillips, 354 S.E.2d 321 (N.C. Ct. App. 1987), In re Estate of Spaziani, 125 Misc. 2d 901 (N.Y. Sur. Ct. 1984), Sorlie v. Ness, 323 N.W.2d 841, 848 (N.D. 1982), In re Estate of Martin, 490 P.2d 14 (Ariz. Ct. App. 1971), Globe Slicing Machine Co. v. Hasner, 333 F.2d 413 (2d Cir. 1964), Vogel v. Melish, 203 N.E.2d 411 (Ill. 1965), Taylor's Adm'r v. Taylor, 301 S.W.2d 579 (Ky. 1957), Elson v. Security State Bank of Allerton, 67 N.W.2d 525 (Iowa 1954), Stern v. Stern, 146 F.2d 870 (D.C. Cir. 1945), Lane v. Albertson, 79 N.Y.S. 947 (N.Y. App. Div. 1903).

[167] *See, e.g.*, AGHDAMI, MANCINI & ZARITSKY: STRUCTURING BUY-SELL AGREEMENTS, *supra* note 2, at *1 ("Specific performance may be the most desirable relief for breach of restrictions in a buy-sell agreement, but it is often the most difficult to obtain." (citation omitted)).

share transfer restrictions and specific testamentary dispositions. The treatment of this discreet aspect of the Virginia Supreme Court's decision in *Dominick*[168] also justifies the timing of this discussion. This separate and distinct, but nevertheless very important aspect of the decision highlights a previously mentioned factor. The determination of the proper remedy in these circumstances highlights the importance and impact on share transfer restrictions of accompanying contract law principles.[169] It therefore merits analysis.

Identifying the proper remedy for enforcement of share transfer restrictions is crucial. Unquestionably, specific enforcement is the starting point. That makes the remedy of specific performance the primary remedy that is likely to be sought.[170] However, the court's decision to grant or deny a litigant the remedy of specific performance is subject to the impact of waiver and estoppel principles. These principles apply because specific performance is an equitable remedy. It is therefore subject to the exercise of the court's equitable discretion. Therefore, the impact of waiver and estoppel principles on the facts and circumstances of any given case demands attention. This impact can often be the determinative factor in controlling the court's grant or denial of specific performance.

The decision in *Dominick*[171] provides insights into the approach of the judiciary in this regard. It highlights judicial approaches in interpreting and applying a clearly and unambiguously drafted stock option purchase agreement. It also demonstrates the court's interpretation of judicially relevant conduct by the parties. More particularly, the conduct of the litigants in the aftermath of the death of one of the parties to the share transfer agreement in controversy required careful analysis. The courts needed to deter-

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[168] *Dominick*, 367 S.E.2d 487. *See also* AGHDAMI, MANCINI & ZARITSKY, *supra* note 167, discussing Stiff v. Stiff, Jr., 989 SW2d 623, 625 (Mo. Ct. App. 1999) (In contrast to the Virginia Supreme Court's decision in *Dominick v. Vassar*, in *Stiff v. Stiff, Jr.*, the Missouri Court of Appeals declined to award the equitable remedy of specific performance based on the specified terms of the specific agreement and in light of all the specific facts of that case).

[169] *E.g.*, the impact of waiver and estoppel principles in light of the facts of the case.

[170] *See* AGHDAMI, MANCINI & ZARITSKY, *supra* note 167.

[171] *Dominick*, 367 S.E.2d 487 (1988).

mine where or not this conduct was dispositive, since specific performance had been sought.

For example, in *Dominick,*[172] the conduct of the litigants at a stockholders' meeting[173] held just short of a month after the decedent stockholder's demise raised significant issues in the subsequent litigation. This shareholders' meeting was held subsequent to the valid probate by the wife of the deceased shareholder of the deceased shareholder's will.[174]

There are no references in the decision to findings of fact that would probably have been critical to the decision had they been known at the time of this stockholders' meeting. For example, there are no references to statements by the surviving stockholder which would have served to make his intentions pertaining to the option clear.[175] He apparently did not declare, disclose, or even intimate that he intended[176] to exercise the option to purchase the decedent's shares.[177] Instead, he essentially facilitated a number of steps taken by the widow[178] of the deceased shareholder. She initiated these steps in an effort to succeed her late husband as the shareholder of record with respect to her deceased husband's shares.[179] The shares had been bequeathed to her.[180]

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[172] *Id.*

[173] The widow of the deceased shareholder attended this shareholders' meeting in her capacity as executrix of her deceased husband's estate under his will, which had now been valid probated by her. Under the terms of her late husband's will, she was also the sole devisee and legatee.

[174] *Id.*

[175] *Id.* at 488 ("No mention was made of the option agreement at the time [of the shareholders' meeting].").

[176] Or did *not* intend.

[177] *But see id.* at 488 n.2 ("In its letter opinion, the trial court stated "[t]here has been *no evidence introduced that either party lacked knowledge of the existence of the ... [a]greement* at the time of the [shareholders' meeting].") (emphasis added).

[178] *Id* at 488. ("At [the] meeting, [the deceased stockholder's wife] was elected a director of [the corporation], along with [the surviving shareholder] and a third party. During the meeting, [the deceased stockholder's wife], as executrix, signed and surrendered two stock certificates aggregating the ... shares that had been issued to her husband .... Upon surrender of the certificates, a new certificate for [all the shares surrendered] was issued to [the deceased stockholder's wife] in her *individual* capacity. The new stock certificate was executed by [the surviving shareholder] as treasurer and by [the deceased stockholder's wife] as president. No mention was made of the option agreement at the time this certificate was issued.") (emphasis added) (citations omitted).

[179] *Dominick*, 367 S.E.2d at 488.

[180] *Id.*

First, at this stockholders' meeting, she was elected as a director of the corporation.[181] At the time of the stockholders' meeting, the decedent's widow had not yet been elected as president of the corporation.[182] However, on the following day, this was rectified at a board of directors' meeting.[183] At this board of directors' meeting – held on the day after the stockholders' meeting – the widow of the deceased shareholder was elected as president of the corporation.[184] In addition, since she was a retiree at the time, she took a full-time position as a salaried employee of the corporation.[185] She also participated, along with the surviving stockholder, in efforts[186] to sell the corporation but retain its real property for rental purposes.[187] As it turned out, in the end, these efforts to sell the corporation were unsuccessful.

Then abruptly, just over a month after the above shareholders' and board of directors' meetings were held, the surviving shareholder changed course. He purported to exercise the option to purchase all of the decedent shareholder's stock.[188] The exercise was affected by written notice to the decedent's estate in accordance with the express terms of the option itself. This service of written notice on the estate of the deceased stockholder was facially impeccable under the terms of the option. It was therefore legally valid.[189] This written notice sought to expressly exercise the option to purchase all the decedent shareholder's shares.[190] Based upon orthodox legal principles pertaining to the valid exercise of an option, the notice was entirely valid.[191]

The deceased shareholder's widow, however, rejected[192] the tender of the surviving shareholder's certified check.[193] The

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[181] *Id.*

[182] *Id.*

[183] *Id.* at n.1 ("[The widow of the deceased stockholder] was actually elected president of [the corporation] at a director's [sic] meeting held the following day.").

[184] *Id.*

[185] Dominick, 367 S.E.2d at 488.

[186] *Id.* These efforts were ultimately unsuccessful.

[187] *Id.*

[188] *Id.*

[189] *Id.*

[190] *Id.*

[191] *Dominick*, 367 S.E.2d at 488. The ninety-day period - after the deceased shareholder's demise - for the legally valid exercise of the option had not yet expired.

[192] *Id.* at 489.

amount of the check tendered by the surviving stockholder had been calculated using the "book value" of the shares as it appeared in the corporation's corporate records.[194] Of course, the surviving shareholder's use of the "book value," was purportedly in accordance with the terms of the option contract.[195] However, perhaps the "commercial value"[196] of the stock was conceivably much higher.[197]

In all likelihood, an increase in value of the corporation's assets over time was more probable than not. Moreover, even in a close corporation,[198] increases in the value of its assets tend to be reflected - to some degree in a concomitant increase in the value of the close corporation's shares as well. Furthermore, an accurate assessment of the commercial realities, which the facts reflected, made it entirely feasible that the acquisition of additional assets over time would enhance the value of the corporation's stock. If acquisition of additional assets had indeed increased the value of the company's shares,[199] then the "book value"[200] of those shares would probably not reflect such increases. The book value on the

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[193] *Id.* at 488-89 ("[The] certified check [was] in the amount of $144,029.50, the book value of the estate's interest in [the corporation]."). Mandating valuation at "book value" in a share transfer restriction is certainly legally permissible. *See, e.g.*, Rudaitis v. Galskis, 233 Ill. App. 414 (Ill. App. Ct. 1924).

[194] *Dominick*, 367 S.E.2d at 488.

[195] *Id.*

[196] For valuation methods relating to stock in close corporations, see Horn v. McQueen, 353 F. Supp. 2d 785, 808 (W.D. Ky. 2004). *See also* Leacock, *supra* note 95, at 102 ("Valuing stock in closely-held corporations is one of the most perplexing problems facing the courts.") (citations omitted).

[197] *Dominick*, 367 S.E.2d at 488 ("When the two stockholders executed the agreement ... [the corporation] owned few assets. By the time [the deceased shareholder passed away] ... however, the corporation had acquired *substantial assets*. Despite the passage of time and [the corporation]'s acquisition of *additional assets*, the agreement was never changed.") (emphasis added).

[198] In a close corporation, the lack of marketability factor has a significant impact upon the valuation of its stock. This lack of marketability may, in some circumstances, impair the progressive increase in the value of a close corporation's stock at a rate that matches the comparable increase in its assets. Lack of marketability can therefore prevent shares in a close corporation from fully reflecting quite genuine increases in the market value of its assets. *See* Leacock, *supra* note 196, at 196.

[199] To *whatever increased* degree of value.

[200] Over time "book value" may often become more and more inaccurate with regard to the most accurate valuation of a corporation's assets. This is the case because very often "book value" consists of the historical value of assets at the time of acquisition by the corporation and tends to *not* reflect increases in the value of such assets that accrued to them after their acquisition by the corporation.

corporation's records would become progressively more and more inaccurate. In fact, it would become so progressively inaccurate because it would have progressively fallen behind the potential market value of the shares. This is a viable proposition in the context of close corporations, in spite of the lack of marketability factor relating to the shares of close corporations.

Therefore, to the extent that it could be determined, it could be argued that the "market value"[201] would be a more accurate valuation method. This was undoubtedly also one of the issues asserted by the deceased shareholder's widow. It would also be one of the bases relied upon by the deceased shareholder's widow in asserting that specific enforcement of the surviving shareholder's option should *not* be ordered by the trial court. The trial court was apparently persuaded by the assertions of the widow of the deceased shareholder. It therefore, denied the surviving shareholder specific enforcement of his option agreement.[202]

The Virginia Supreme Court reversed the trial court and remanded the case for entry of a decree consistent with its opinion.[203] The Virginia Supreme Court certainly did not perceive the trial court's decision as a partisan rant in favor of the widow. Nor did the Virginia Supreme Court refer to the slightest hint of sympathy for her in the trial court's decision. Rather, the Virginia Supreme Court concluded that "[t]he trial court did not address specifically the elements of equitable estoppel."[204] The Virginia Supreme Court also acknowledged a fundamental tenet relating to the proof necessary to succeed in procuring an award of specific per-

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[201] *See id.* With all the attendant difficulties in determining what is genuinely the market value of the stock in a close corporation.

[202] *See Dominick*, 367 S.E.2d at 489 ("After considering [the] undisputed facts, the trial court refused to specifically enforce the agreement. The court opined that [the surviving stockholder] was 'barred by estoppel from asserting his right of option to purchase pursuant to the [a]greement ... against [the decedent shareholder's widow].'").

[203] *Id.* at 490.

[204] *Id.* at 489. With respect to the specific elements of equitable estoppel, *see, e.g.*, Stephen J. Leacock, *Fingerprints of Equitable Estoppel and Promissory Estoppel on the Statute of Frauds in Contract Law*, 2 WM. & MARY BUS. L. REV. 73, 90 (2011). The principles applicable to equitable estoppel were enunciated and discussed in the context of the legal resolution of issues pertaining to the Statute of Frauds in contract law. However, the enunciated principles and the factors relating to proof of the requirements necessary for success based upon an assertion of equitable estoppel similarly apply in the context of share transfer restrictions.

formance.[205] Since the grant or refusal of specific performance is a fundamental function of the exercise of the trial court's discretion, the reversal of a trial court's decision is unusual. This is what makes this separate but particularly important aspect of the Virginia Supreme Court's decision so compelling.

At least two substantively similar but alternative arguments merit discussion. First, proof of equitable estoppel[206] looms large in the Virginia Supreme Court's decision. Second, proof of waiver *combined* with estoppel also merits discussion. Of course, to a substantial degree, the substantive components of these two equitable arguments coincide. As a result, where this is the case, the discussion of both of these two alternative arguments will be combined.

With regard to equitable estoppel, the Virginia Supreme Court very carefully and completely analyzed equitable estoppel's role in controlling the outcome in the case.[207] Moreover, courts are particularly attentive in identifying the critical elements necessary to successfully prove equitable estoppel.[208] In this regard, at first blush, full and complete articulations by courts of these necessary elements for success may appear to differ.[209] However, the substantive quintessence remains constant.[210] Moreover, courts all agree that *all* the elements articulated must be proven. Inevitably, therefore, a failure to prove any *one* of the required components is fatal to a party's success in achieving proof of equitable estoppel.[211]

With respect to the substantive elements necessary for the successful invocation of equitable estoppel, three examples of court articulation of the required proof should help immeasurably.

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[205] *Dominick*, 367 S.E.2d at 489 ("Specific performance is not a remedy of right but one that *rests within the sound discretion of the trial court*.") (emphasis added) (citations omitted).

[206] *See* Irwin v. West End Development Co., 342 F Supp. at 697 ("Generally speaking ... equitable estoppel is a rule of justice which *in its proper field prevails over all other rules*.") (emphasis added) (citation omitted).

[207] *Dominick*, 367 S.E.2d at 489-90.

[208] *See, e.g.*, Leacock, *supra* note 204, at 90-91.

[209] *Id.*

[210] *Id.*

[211] *Id.*

First, the Appellate Court of Illinois[212] enunciated five indispensable elements as necessary components for successful proof of equitable estoppel.[213] In contrast, the Nebraska Court of Appeals articulated six elements as an irreducible minimum of conditions precedent to successful proof of this equitable concept.[214] The Supreme Judicial Court of Massachusetts, Middlesex, however, identified just three necessary elements for success.[215]

The articulation of the specific total number of requirements for successful proof of equitable estoppel demonstrates the *individual* articulation preferences by these courts. However, the fundamental substance of successful proof of equitable estoppel remains constant and unwavering for all of these courts. Irrefutably, the quintessence of the proof necessary for success in establishing all the requirements of equitable estoppel is translucent and unchallenged.[216] Thus, the Virginia Supreme Court analyzed the

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[212] *See* Derby Meadows Util. Co. v. Vill. of Orland Park, 559 N.E.2d 986, 995 (Ill. App. Ct. 1990).

[213] *See id.* ("The elements of *equitable* estoppel are: (1) words or conduct by the party against whom the estoppel is alleged consisting of misrepresentations or concealment of material facts; (2) the party against whom the estoppel is alleged must have actual or implied knowledge at the time the representations are made that they are untrue; (3) the truth regarding the representations is unknown to the party claiming the benefit of estoppel both at the time they are made and when they are acted on by him; (4) the party estopped must intend or expect that his conduct or representations will be acted on by the party claiming estoppel; (5) the party claiming estoppel does rely and act on the representations and in such a manner, that he would be prejudiced if the party making the representations is allowed to deny the truth thereof.") (citations omitted) (emphasis added).

[214] *See* Lowe v. Lancaster County Sch. Dist. 0001, 766 N.W.2d 408, 415 (Neb. Ct. App. 2009) ("Six elements must be satisfied for the doctrine of equitable estoppel to apply: (1) conduct which amounts to a false representation or concealment of material facts or, at least, which is calculated to convey the impression that the facts are otherwise than, and inconsistent with, those which the party subsequently attempts to assert; (2) the intention, or at least the expectation, that such conduct will be acted upon by, or influence, the other party or other persons; (3) knowledge, actual or constructive, of the real facts; (4) lack of knowledge and the means of knowledge of the truth as to the facts in question; (5) reliance, in good faith, upon the conduct or statements of the party to be estopped; and (6) action or inaction based thereon of such a character as to change the position or status of the party claiming the estoppel.") (citations omitted).

[215] *See* Maffei v. Roman Catholic Archbishop of Boston, 867 N.E.2d 300, 318 n.30 (Mass. 2007) ("[Equitable] [e]stoppel *may* prevail ... where the litigant claiming estoppel proves: '(1.) A representation or conduct amounting to a representation intended to induce a course of conduct on the part of the person to whom the representation is made. (2.) An act or omission resulting from the representation, whether actual or by conduct .... (3.) Detriment to such person as a consequence of the act or omission.'") (emphasis added) (citations omitted).

[216] *See supra* notes 212-215.

facts and circumstances presented in *Dominick*[217] in order to determine whether the objective substance underlying the requirements for successful proof of equitable estoppel was properly presented.

The first step required for successful proof was potentially satisfied. This first step may be articulated as proof that the surviving stockholder's words or conduct rose to the level of misrepresentation or concealment of one or more material facts.[218]

Of course, based upon the facts presented in the case, there was no indication that the surviving stockholder had actively lied to the widow. There was no proof of the active misrepresentation of any material fact by him. No facts indicated that he stated to her that he would *not* exercise the option within the ninety day period. Nor was it proven that he had shown any callous disregard for what she may have reasonably thought.

However, misleading someone can take several forms. Undoubtedly, the surviving stockholder had, at a bare minimum, passively stood by while the deceased shareholder's widow actively took a number of judicially relevant steps. She took these steps in order to lawfully transfer to herself personally - title to the shares of her deceased husband.[219] It could also be argued that the surviving stockholder actively participated in and facilitated this transfer on the corporation's records.[220] To a certain degree, he assisted her in becoming the shareholder of record for the pertinent shares.[221] Furthermore, taken altogether, the surviving shareholder's conduct might have amounted to a concealment of an identifiably material fact.

That material fact would consist of concealment of the surviving stockholder's actual intention.[222] His conduct was not unequivocally indicative of an intention to exercise the option at all. On the contrary, his actions seem to be more consistent with an

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[217] 367 S.E.2d at 487.

[218] *See supra* notes 212-215.

[219] *Dominick*, 367 S.E.2d at 488.

[220] *Id.*

[221] *Id.*

[222] If, indeed it was *truthfully* the surviving shareholder's *present* intention to exercise the option before it expired anyway, and in reality, the surviving stockholder was simply leading the widow of the deceased stockholder astray by misleading her into thinking that his actual intention was genuinely to decline the exercise of the option altogether.

intention *not* to exercise the option. Of course, the issue of his exercise of the option *within* the permissible ninety days contractually agreed under the terms of the option itself was more equivocal. Human beings often change their minds.

In actuality, a period of ninety days had *not* yet elapsed when the surviving stockholder rendered his assistance to the decedent stockholder's widow. Furthermore, the surviving stockholder may have *truthfully* not yet decided whether or not to exercise the option in the first place. Therefore, the neutrally accurate legal conclusion was that the option was still perfectly valid. Ninety days had not yet elapsed since the decedent's demise. The surviving stockholder's option had not legally terminated by effluxion of time.[223] On the contrary, the option remained legally valid and therefore subject to its effective activation and exercise by the surviving stockholder. To be even more accurate, such exercise remained legally viable at any time before the ninety day limit expired.

Alternatively, an argument that is substantively similar to the equitable estoppel argument might have been available to the widow as well and is unquestionably feasible on the facts of the case. This alternative argument by the widow of the decedent shareholder implicates an additional question: whether the surviving stockholder's conduct was sufficient to meet the requirements for successful proof of waiver. In substance, had he waived his right to exercise the option?

This alternative argument would implicate an effort by the decedent's widow to prove all the elements of waiver properly combined with estoppel. Based upon equitable principles, successful proof of both of these elements could also bar the successful exercise of the option by the surviving stockholder. Moreover, the question of waiver by the surviving stockholder of the right to exercise the option can be analyzed as follows.

Of course, proof of waiver, standing on its own, would be insufficient to nullify the surviving stockholder's option. Instead, proof of waiver would need to be successfully combined with proof that the surviving stockholder should be estopped by the courts from exercising the option. This proof of estoppel would require an additional fundamental element. It would require proof

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[223] Or on any other *viable* legal basis.

by the widow of a material change in her position to her detriment in reliance upon the surviving stockholder's waiver. This additional element substantively aligns the equitable estoppel argument with the proof of waiver combined with estoppel argument. Therefore, the two arguments will both be discussed together as follows.

The relative legal force of these two complementary equitable arguments requires assessment. In this regard, everyone is presumed to know the law.[224] The presumption applies in the civil context.[225] This legal maxim was unquestionably applicable to the widow. However, the surviving shareholder's conduct in facilitating the widow's acquisition of the status of shareholder of record personally may have misled the decedent's widow. The surviving stockholder's behavior may have indicated an intention *not* to exercise the option at all. Alternatively, it may have created an impression that he had waived his right to exercise the option altogether.

With regard to his intention, irrefutably, a person's intention is an inner objective fact.[226] Moreover, it can be argued that the surviving shareholder's objective intention to exercise or not to exercise the option would influence a reasonable person's decision in the circumstances. This would make the issue relating to the exercise of the option material. Therefore, the surviving shareholder's objective intention with respect to the exercise of the option was arguably material.[227] This interpretation suggests that a reasonable person in the position of the widow of the deceased shareholder would probably treat the surviving shareholder's decision[228] as a significant factor in influencing her own conduct to

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[224] *See, e.g.*, Ahrens v. State, 709 S.E.2d 54, 62 (S.C. 2011) (Acknowledging "the well-established rule that citizens are presumed to know the law and are charged with using care to protect their interests ....").

[225] *Id.*

[226] *See, e.g.*, 36A C.J.S. Fixtures § 8. (June 2011). ("[T]he *objective intent* of [a party] can be inferred from the [party]'s acts, and other objective, visible facts.") (emphasis added) (citations omitted). These principles enunciated in the context of the legal resolution of issues pertaining to fixtures in real property law apply equally in the share transfer restriction context.

[227] *See, e.g.*, Coble v. Denison, 131 S.W. 719, 720 (Mo. Ct. App. 1910). ("When ... the circumstances disclose a *material* intention ... [it] ... will be enforced ....") (emphasis added). *See also supra* note 143 (addressing context).

[228] To exercise or *not* to exercise the option.

seek to become or not to become a shareholder of record *personally*.

The exercise, non-exercise, or waiver of the option would arguably influence the decision of a reasonable person in similar circumstances. With respect to the shares at issue, it would certainly influence her own conduct in seeking or declining to pursue any change in the identity of the shareholder of record on the corporation's record of shareholders. It would determine whether or not she would actively initiate and complete the transfer of the decedent's shareholder's shares to herself personally. It probably did.

Based upon the above discussion, the first requirement for successful proof of equitable estoppel *may* very well have been achieved by the widow of the deceased shareholder. The surviving stockholder's provision of active assistance to the decedent shareholder's widow was highly relevant to the issue of the surviving stockholder's intent. The widow's advocate could have asserted that the surviving stockholder's provision to the widow of assistance in personally becoming the shareholder of record on the corporation's records was compelling. This provision of assistance to the widow could be perceived by a reasonable person as the best single indicator of the surviving stockholder's intention. The widow's advocate could have used such an approach in order to clinch success in proving the first requirement. It could amount to legally sufficient proof of the inner fact. The surviving stockholder's assistance could conceivably be reasonably interpreted as an objective indication that the surviving shareholder did *not* intend to exercise his option after all.

Alternatively, it can be asserted that the surviving stockholder's conduct was critically relevant in another respect. It was critically relevant to the determination of whether or not the surviving stockholder had waived his right to exercise the option. The surviving stockholder's provision to the widow of assistance in personally becoming the shareholder of record on the corporation's records could be interpreted as an objective indication that he had waived his right to exercise the option. Indeed, based upon the provision of this level of assistance by the surviving stockholder to the widow, a reasonable person could quite easily conclude that the surviving shareholder had decided to waive his right to exercise the option. In fact, the surviving stockholder's behavior may have

been sufficient to adequately support successful proof of a waiver by him of the exercise of the option. It could probably be forcefully argued that it was *conclusive* proof of a waiver by him. This may be credible in spite of the fact that ninety days had not yet elapsed since the decedent shareholder's unfortunate demise.

If these observations are all accurate,[229] then, the following points of view would become tenable. First of all, the second requirement for successful proof of equitable estoppel would take center stage. Furthermore, this substantive proof of waiver, if successful, would also focus attention on whether or not the activation of the component of estoppel was attained in support of the widow's alternative argument. As indicated earlier, proof of estoppel is required in combination with proof of waiver in order for the widow to achieve success based upon the second alternative argument outlined above.

In this regard, the legal effect of the widow's change in position to personally become a shareholder of record of the corporation would become a fundamental legal factor. This is the case because the court would need to determine whether the widow *materially* changed her position *to her detriment*.[230] She would have needed to persuade the court that any change which she had been influenced to make was value-diminishing rather than value-enhancing with respect to her late husband's stock.

In order for the widow to garner success based upon proof of waiver combined with proof of estoppel, she would be required to also prove a substantively similar additional component. Proof of a material change in her position to her detriment is that critically important additional element. Moreover, in the context of waiver, the widow's task to earn success against the surviving stock-

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[229] Conceivably, the surviving shareholder's advocate could have "given ground" on whether the *initial* requirement for successful proof of the elements of equitable estoppel and also for proof of waiver had been met. The surviving stockholder's advocate *could* have conceded this in order to actually *enhance* her (or his) credibility in court in relation to the presentation of follow up arguments – on the surviving stockholder's behalf – designed to nullify the widow's efforts to establish the *other elements* necessary for successful proof of equitable estoppel and, in the alternative, waiver combined with estoppel. *See, e.g.*, *Justice Clarence Thomas Interview*, 13 SCRIBES J. OF LEGAL WRITING 99, 108 (2010) ("[S]imply by admitting that there's a flaw someplace ... I think [that] when you give ground, you *gain credibility*. When you hold ground that you *don't deserve*, you do *not* gain credibility, you *lose credibility*." (emphasis added)).

[230] *See supra* notes 212-215.

holder is more onerous because a waiver can be revoked prior to any material change in position by the widow to her detriment. This is the case, provided that the widow had not *already materially* changed her position *to her detriment.*

Therefore, in appropriate circumstances, notice to the widow of the surviving stockholder's intention to exercise the option could have fundamental legal repercussions. Such notice, if timely, could validly revoke any earlier waiver by the surviving stockholder of his option to purchase the decedent shareholder's stock. The provision of this legally valid notice would nullify the widow's prospects of success based upon the second alternative of proof identified above. It would terminate the viability of her assertions based upon proof of waiver combined with proof of estoppel.

However, on these facts, it can be asserted that the widow's change in position was to her *betterment* rather than to her detriment.[231] Proof that her change in position was a positive rather than a negative one[232] would clearly undermine the prospect of any success predicated upon both of her alternative arguments. On the facts of the case, a judgment in her favor would have toppled equitable estoppel onto its head. Achieving success in her assertions absolutely depended upon sustaining the viability of *all* the critical elements necessary for valid proof of equitable estoppel.

It would also nullify her prospects of success based upon her alternative strategy of attempting to prove waiver combined with estoppel as well. Of necessity, successful proof of equitable estoppel as well as successful proof of waiver combined with estoppel both require proof by the widow of material *impairment*[233] caused by the facts and circumstances presented in the case.

In *Dominick*, such proof was not forthcoming in the context of the facts and circumstances before the court. Therefore, both of these two equitable barriers to enforcement of the option were precluded. This preclusion was fatal to both alternatives of the arguments available for presentation by the widow. Unfortunately, her

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[231] *See supra* note 219.

[232] Conceivably caused by the surviving shareholder's entire conduct, taken as a whole, when such conduct was objectively observed by a reasonable person.

[233] Not its *antithesis*.

efforts to overcome the hurdles that she faced in presenting her arguments were an attempt to surmount the insurmountable.

A different legal outcome may have been achieved by the decedent's widow if the facts of the case were different. For example, the joint efforts put forth by the widow and the surviving stockholder to sell the corporation's business[234] as a going concern *could* have been successful. Hypothetically, this could have been accomplished while the option was still valid.[235] Moreover, after the corporation's business had been successfully sold as a going concern, the surviving shareholder could then have sought to exercise the option.

If the surviving stockholder had done so, then potent equitable ammunition may have become available to the widow.[236] Under these changed facts, her prospects of success in invoking equitable estoppel or waiver combined with estoppel might have soared. She could then have argued unconscionability based upon the surviving stockholder's unjust enrichment at her expense. Arguably, such conduct by the surviving stockholder would be equitably unscrupulous and therefore legally impermissible. It would be unconscionable for the court to permit the surviving shareholder to exercise the option and purchase the deceased stockholder's shares at "book value" as the option mandated. This would have been an equitably abhorrent outcome.

The purchase by the surviving stockholder of the decedent shareholder's share at "book value" would have excluded the enhanced value added by the success in selling the corporation's business "as a going concern."[237] On principle, sale of a business as a going concern maximizes the value of the business much more effectively than valuing such a business based upon its "book value."[238] This value maximization would have been accomplished by the joint efforts of the surviving stockholder *and the widow*. Court

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[234] *Dominick*, 367 S.E.2d at 488 ("[The decedent's widow] and [the surviving shareholder] endeavored, albeit unsuccessfully, to sell the business and retain [the corporation]'s real estate for rental purposes.").

[235] *I.e.* within ninety days subsequent to the decedent shareholder's demise.

[236] This would consist of the widow's contributions to achieving the successful sale of the corporation's business.

[237] *See, e.g.*, Golden Telecom, Inc. v. Global GT LP, 11 A.3d 214, 217 at n.5 (Del. 2010) ("We have long recognized that failure to value a company as a going concern *may* result in an *understatement of fair value*.") (emphasis added).

[238] *Id.*

enforcement of the option on these changed facts would have meant that the court would have inequitably assisted the surviving shareholder at the expense of the widow. The court would have unfairly assisted the surviving stockholder in shrewdly and inequitably outmaneuvering the widow. The court would probably have been reluctant to do so. Such judicial conduct may have been the provision of inequitable judicial assistance to the surviving stockholder. The court would therefore not have done it.

On these hypothetical facts, it would have been inequitable if the surviving stockholder were permitted by the court to use a valuation of the decedent's shares at "book value" as the option required. This is the case because the use of "book value" would nullify the widow's contribution in getting the corporation sold. The successful sale would have unquestionably enhanced the total value of the corporation. The use of "book value" by the surviving stockholder would exclude this entire value-enhancement from the valuation of the shares. This is precisely what the exercise of the option would achieve in the context of these changed facts, if they were the case.

Therefore, on these hypothetical facts, the Virginia Supreme Court would have been unlikely to grant the surviving stockholder specific performance of the option as it did on the facts of the case.

Such a grant of specific enforcement would have assisted the surviving stockholder *alone* in harvesting the entire bounty of the combined joint efforts put forth by the widow and the surviving stockholder. The Court would have inequitably validated exploitation of the widow's assistance. It would have financially abused her at the very least. The court would have plucked from her justified receipt and enjoyment of the fair share of the proceeds of these joint efforts. On such changed facts, she would have been fairly and equitably entitled to receive and enjoy her aliquot portion of this jointly-produced enhanced value.

The differences between the facts of the hypothetical and those in *Dominick*[239] are demonstrably fundamental. As a result, on the facts of *Dominick*, traversing the hurdles of proof of equitable estoppel and waiver combined with estoppel were simply two hurdles too many for the decedent's widow to surmount. This led

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[239] *Dominick*, 367 S.E.2d 487.

the Virginia Supreme Court to exercise its own judicial delicacy and skill. On the facts of the case, it may have seemed to the Virginia Supreme Court that not by any stretch of judicial imagination could the trial court's decision be tenable. The Virginia Supreme Court therefore overruled the trial court's decision.[240]

In doing so, the Virginia Supreme Court took the relatively unusual step of reversing the trial court's exercise of its discretion.[241] In the absence of valid proof of all the requirements of equitable estoppel, and waiver combined with estoppel, the trial court's exercise of its discretion in favor of the decedent's widow was legally inappropriate. Therefore, in the opinion of the Virginia Supreme Court, the trial court's denial of specific performance to the surviving stockholder was legally untenable.[242] That is the clearly justifiable reason why the trial court's judgment should have been reversed by the Virginia Supreme Court. The reversal made good sense.

C. Specific Applications of Share Transfer Restrictions[243]

1. Rights of First-Refusal/Buy-Sell Agreements

The legal principles applicable to rights of first refusal, commonly referred to as buy-sell agreements, are synonymous with the principles identified and analyzed earlier. Where stockholders in close corporations intend to transfer shares, rights of first refusal demonstrate these legal principles. Such rights may be owned by the corporation itself or the pertinent rights *may* be owned by fellow shareholders of the selling stockholder. Success in creating a valid, binding and enforceable right of first refusal – or other similar restriction – is the focus of similarly critical attention.

Such rights must be articulated and embedded in the share transfer restriction in language that clearly and explicitly makes the restriction or restrictions *intentionally* applicable to dispositions by

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[240] *Id.*

[241] *Id.*

[242] *Id.*

[243] *See, e.g.*, FARHAD, MANCINI & ZARITSKY, *supra* note 2 at *1 ("As a practical matter . . . restriction[s] on sales and exchanges of business interests should be considered together with restrictions on other *voluntary* transfers, such as gifts and part-sales/part-gifts.") (emphasis added).

testamentary transfer.[244] The courts do not tend to imply such applicability at all. Explicit language fiercely controls each legal outcome. Silence with respect to a share transfer restriction's legal impact upon a testamentary provision is not an advisable drafting technique. As a consequence, proof of an objective intention to amplify a restriction beyond its actual rhetoric will be unavoidably problematical in every instance where the judiciary interprets such restrictions.

2. *Testamentary Dispositions*[245]

In the context of specific testamentary dispositions, the significance of precision and clarity as discussed above is probably elevated exponentially.[246] Fundamentally, the judiciary has concluded that share transfer restrictions presumptively apply to *voluntary* transfers of stock.[247] The judiciary has, however, also ruled that share transfer restrictions are to be interpreted as drafted.[248] The above discussion of the Virginia Supreme Court's decision in *Dominick v. Vassar*, demonstrates that disposition by will can be superseded by clearly drafted share transfer restrictions.[249] The necessary skill, clarity, and acuity must be clearly evident in drafting a specific share transfer restriction in order to fully extend its reach and application. If the provisions of the specific share transfer restriction are clear and unambiguous, the approach of the courts is to allocate to testamentary dispositions no greater priority than *inter vivos* contractual provisions.

This makes sense. There is no convincing reason why testamentary dispositions of shares should be singled out for *sui generis* treatment. Testamentary dispositions need not be legally per-

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[244] *See* Glenn v. Seaview Country Club, 380 A.2d 1175, 1176-77 (N.J. Super. Ch. Div. 1977).

[245] *See* In re Estate of Riggs, 540 P.2d 361, 363 (Colo. App. 1975) ("[T]he majority rule [is] that, *unless otherwise provided therein*, restrictions on alienability do not apply to testamentary disposition.") (emphasis added) (citation omitted).

[246] *See* Witte v. Beverly Lakes Inv. Co., 715 S.W.2d 286, 292 (Mo. Ct. App. 1986) ("An intention to restrict a transfer . must be manifest from the words of limitation, and will *not* be assumed. A restriction, *clearly expressed* will be enforced . .") (emphasis added) (citations omitted).

[247] *See* Globe Slicing Mach. Co. v. Hasner, 333 F.2d 413, 415 (2nd Cir. 1964) ("First option provisions in order effectively to restrain dispositions by will must *specifically* so provide.") (emphasis added).

[248] *See* Dominick, 367 S.E.2d at 487.

[249] *Id.*

mitted to leapfrog other valid contractual dispositions that *predate* such testamentary dispositions. Nor should testamentary dispositions be interpreted to supplant earlier, valid, lawful obligations of a testator which linguistically supersede them. Essentially, an earlier obligation that was freely agreed to by the testator without any proof of coercion or constraints should be enforced without judicial hesitation.

It is certainly conceded that genuine conflict between share transfer restrictions and testamentary dispositions merit transcendent scrutiny. When such conflicts are proven, the language of the particular share transfer restriction should be treated by the courts as determinative. It is.[250] Certainly, where carefully drafted share transfer restrictions explicitly articulate which of the two shall prevail over the other, courts enforce the stated choice. Freedom of contract rationally supports such conclusions. It is therefore valid to propose that court elevation of the express or implied preeminence of share transfer restrictions over testamentary dispositions is the norm. In the face of clearly drafted share transfer restrictions, courts elevate the expressly stated choice to the level of determinative status. The judiciary has enforced unambiguously drafted share transfer restrictions ubiquitously.[251]

Courts *should* enforce clearly drafted restrictions. Concomitantly, courts have not enforced those that were not clearly drafted. This is the case whether the specific restrictions were placed in corporate bylaws,[252] in stockholders' agreements,[253] or in a corporation's articles of incorporation.[254] Thus, validity and applicability depend upon explicit drafting. Skill-based dynamics predominate. Consequently, documentary location of a particular share transfer restriction does not tend to be relevant or significant.

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[250] *See* Witte v. Beverly Lakes Inv. Co., 715 S.W.2d 286 (Mo. Ct. App. 1986).

[251] *See* In re Estate of Martin, 490 P.2d 14, 16 (Ariz. App. 1971) ([S]ince there is *no express restriction on testamentary disposition* in the present case the rule of strict construction inhibits such restriction by implication.") (emphasis added) (citation omitted) Stern v. Stern, 146 F.2d at 870, Elson v. Sec.Security State Bank of Allerton, 67 N.W.2d 525, 526; (Iowa 1954), Taylor's Adm'r v. Taylor, 301 S.W.2d 579, 581-82, (Ky. Ct. App. 1957), *Globe Slicing Mach.*, 333 F.2d at 414.

[252] *Globe Slicing Mach.*, 333 F.2d at 414.

[253] *Dominick*, 367 S.E.2d at 487; *see Vogel*, 203 N.E.2d at 413 ("[T]here is *no express restriction* on intestate or testamentary disposition, and under the rule of strict construction, none can be implied.") (emphasis added).

[254] Lane v. Albertson, 79 N.Y.S. 947 (N.Y. App. Div. 1903).

As a result, whether or not the restrictions upon testamentary disposition of stock are located in the articles, certificate of incorporation, bylaws, or in a separate written agreement among shareholders is certainly not dispositive.

3. Involuntary Transfers Generally

Proof of an intention to make the share transfer restriction legally operable - prior to an involuntary transfer is no "walk in the park" either. The preeminence of a share transfer restriction over a stock transfer that is ordered by judicial decree, or otherwise imposed involuntarily by operation of law, must be gleaned from the language of the restriction itself. It will *not* be readily implied or assumed.[255]

As explained earlier, in instances where courts have held that the right of first refusal did *not* extend or apply to testamentary transfers, the objective intention of the instrument triumphed. Words evidencing that objective intention and, therefore, the irrefutable legal effect of the provision were critical. Inevitably, restricting the transfer of stock was presumptively interpreted by the courts to make it applicable when the stock was *voluntarily* transferred by the transferor. This typically means *sold* to a third party. In the absence of specific provisions that so stated, a share transfer restriction will not be interpreted to apply to testamentary transfers or other involuntary transfers at all.[256]

As the earlier discussion has indicated, courts apply the rule of *strict* construction. Thus, no restriction on testamentary dispositions will be implied if none is expressly provided.[257] Moreover, a recital forbidding a stockholder to "sell, transfer, assign, convey or otherwise dispose of" has been held *not* to imply a restriction on testamentary disposition. This ruling was made in spite of an explicit provision that the restriction should be 'binding upon and inured to the benefit of the parties' respective heirs, executors and administrators."[258] Clarity and the elimination of all ambiguity are indispensable. These two mandates cannot be overemphasized.

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[255] *Witte*, 715 S.W.2d at 291-92.

[256] *Id.*

[257] *In re Estate of Martin*, 490 P.2d at 15.

[258] *Vogel*, 203 N.E.2d at 414.

VI. RIGHT OF ALIENATION AND CONCEPTIONS OF REASONABLENESS

As the earlier discussion has indicated, viable share transfer restrictions must be specific in their terms and all rights of the parties must be clear and unambiguous.[259] Moreover, the historical perspective has charted why courts do not favor restraints on the right of alienation of corporate stock.[260] This further explains why the common law construes share transfer restrictions as strictly as it does.[261] This legal value-judgment is applied to any provision purporting to prevent stock transfers to *non-shareholders* of a close corporation without first offering the shares to other stockholders or alternatively, to the corporation.[262] Logically therefore, courts are reluctant to extend express restrictive provisions by judicial implication.[263] As a result, share transfer restriction rights will be upheld *only* if the courts rule that they are reasonable and therefore lawful.[264]

Successful proof of the reasonableness of restrictions on transfers of corporate stock requires a clear showing that the restraint is sufficiently necessary for preserving the business integrity of the particular enterprise. Such proof must be forceful enough to override the fundamental judicial policy of reluctance to validate

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[259] *See* Stiegler v. Dittman, 584 So.2d 507, 517-18 (Ala. 1991), Birmingham Artificial Limb Co. v. Allen, 194 So.2d 848, 849-50 (Ala. 1967), Monacan Hills, Inc. v. Page, 122 S.E.2d 654, 657 (Va. 1961), Miskowitz v. Starobin, 41 N.Y.S.2d 786, 789 (N.Y. Sup. Ct. 1943).

[260] *See also* In re Estate of Martin, 490 P.2d at 15 ("Restrictions on the alienation or transfer of corporate stock are *not* looked upon with favor....") (emphasis added).

[261] *In re Estate of Martin*, 490 P.2d at 15; *see also* Tu-Vu Drive-In Corp. v. Ashkins, 391 P.2d 828, 830 (Cal. 1964) (en banc), In re Estate of Riggs, 540 P.2d 361, 363 (Colo. Ct. App. 1975); *Taylor's Adm'r*, 301 S.W.2d at 583.

[262] *See* Elson v. Sec. State Bank of Allerton, 67 N.W.2d 525, 527 (Iowa 1954); *see* Guar. Laundry Co. v. Pulliam, 181 P.2d at 1007.

[263] Guar. Laundry Co. v. Pulliam, 181 P.2d at 1009; *see Taylor's*, 301 S.W.2d at 583, Bos. Safe Deposit & Trust Co. v. N. Attleborough Chapter of Am. Red Cross, 111 N.E.2d 447, 449 (Mass. 1953).

[264] *In Re Estate of Martin*, 490 P.2d at 15 ;(citing FLETCHER, *supra* note 1, § 4205 (perm. ed. 1966));570-71; *Ashkins*, 391 P.2d at 830 (citing F. HODGE O'NEAL, RESTRICTIONS ON TRANSFER OF STOCK IN CLOSELY HELD CORPORATIONS: PLANNING AND DRAFTING, 65 Harv. L. Rev. 773, 777-78 (1952)); *Taylor's Adm'r*, 301 S.W.2d at 582 (citing 13 AM. JUR. 2D CORPORATIONS §§ 329, 335, 338 (2011)).

the particular restraint on alienation.[265] Courts will not hesitate to declare bylaws that *absolutely* prohibit transfers of shares to be unlawful restraints on the alienation of corporate stock and therefore irrefutably null and void.[266]

These consist of mandatory rather than permissive bylaws. Examples are bylaws that provide that *before* a shareholder may sell or transfer stock to non-shareholders, the selling shareholder *must* bow to someone's discretion as specified. Namely, the sale is prohibited even if the corporation, or the other shareholder(s), or an appointee of the one or the other, declines the opportunity or option of purchasing it.[267] Moreover, disguises are futile. Attempts to disguise the dogma of an absolute restriction as a discretionary measure will not confuse the eye of equity. Such attempts will fail miserably.

For example, a provision which subjects transfers to the unrestrained discretion of identified parties will fare no better. The selection of the corporation, its directors, officers, or other shareholders as the recipient of the pertinent unrestrained discretion will not improve the prospects of success. All such initiatives will be nullified by the courts. In exceptional circumstances, however, subtle advocacy may be enough to convince the court that a provision is not objectively absolute. In such circumstances, judicial wariness and circumspection may be overcome and the particular court may relent.

Of course, courts may grant enforcement where a statute, charter, or the articles of incorporation empower a bylaw to impose partial or temporary restrictions. Such limited restrictions on rights to freely transfer shares need to be legally justified. However, the use of any artifice whatsoever is unequivocally discouraged. Transparency is respected by the judiciary. The particular restrictions must be objectively proven to be for the purpose of pro-

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[265] Burns v. Burns, 789 So. 2d 94, 99-100 (Miss. Ct. App. 2000) (citing Fayard v. Fayard, 293 So. 2d 421, 423 (Miss.1974)).

[266] *Witte*, 715 S.W.2d at 291.

[267] Shuping v. NCNB Nat'l Bank of N.C., 377 S.E.2d 802 (N.C. Ct. App. 1989); Mancini v. Setaro, 232 P. 495, (Cal. Dist. Ct. App. 1924); Steele v. Farmers' & Merchants' Mut. Tel. Ass'n, 148 P. 661 (Kan. 1915); Morris v. Hussong Dyeing Mach. Co., 86 A. 1026 (N.J. Ch. 1913); In re Laun, 131 N.W. 366 (Wis. 1911); Victor G. Bloede Co. v. Bloede, 34 A. 1127 (Md. 1896); Brinkerhoff-Farris Trust & Sav. Co. v. Home Lumber Co., 24 S.W. 129 (Mo. 1893).

tecting the corporation.[268] Since transfer-restrictive bylaws are, on principle, not illegal *per se*, courts will uphold as valid transfer-restrictive bylaws that are proper enough to be treated as reasonable.[269] Reasonableness in this context is, after all, akin to a Rorschach or litmus test.[270] To be sure, share transfer restrictions are not at all objectionable *per se*.[271]

Restrictions that do not unreasonably restrict the right of alienation, nor unreasonably deprive a non-consenting shareholder of substantial rights will be validated.[272] These court decisions satisfy any rational rule of reason and vindicate practical business objectives. This is, of course, judicially tolerable in the context of a much narrower genre of close corporation. Such close corporations do need to be of a special nature or need to exist for particular purposes.[273] Of course, at first blush, this seems to challenge the premise of the rule of reason. However, credible support for such decisions may be forthcoming. Unusual facts may support what may seem at first to be untenable outcomes. The discussion below examines court interpretation in action.

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[268] Davis v. Davis, 419 S.E.2d 913 (Ga. 1992); Allen v. Biltmore Tissue Corp, 141 N.E.2d 812 (N.Y. 1957).

[269] *Allen*, 141 N.E.2d at 817.

[270] In re Estate of Croonberg, 988 P.2d 41 (Wyo. 1999); Remillong v. Schneider, 185 N.W.2d 493 (N.D. 1971); Mary v. Wilcox Furniture Downtown, Inc., 450 S.W.2d 734 (Tex. Civ. App. Corpus Christi 1969); Campbell v. Campbell, 422 P.2d 932 (Kan. 1967); Colbert v. Hennessey, 217 N.E.2d 914 (Mass. 1966); Indiana *ex rel.* Hudelson*State* v. Clarks Hill Tel. Co., 218 N.E.2d 154 (Ind. Ct. App. 1966); Clayton v. James B. Clow & Sons, 327 F.2d 382 (7th Cir. Ill. 1964); In re Estate of Mather, 189 A.2d 586 (Pa. 1963); Ky. Package Store, Inc. v. Checani, 117 N.E.2d 139 (Mass. 1954); Allen, 141 N.E.2d 812; *Dobry*, 262 P.2d 691; First Nat'l Bank of Canton v. Shanks, 73 N.E.2d 93 (Ohio Ct. Com. Pl.C.P. 1945); Bushway Ice Cream Co. v. Fred H. Bean Co., 187 N.E. 537 (Mass. 1933); Doss v. Yingling, 185 N.E. 281 (Ind. 1933); Vannucci v. Pedrini, 17 P.2d 706 (Cal. 1932); Rychwalski v. Milwaukee Candy Co.,, 236 N.W. 131 (Wis. 1931); Brown v. Little, Brown & Co., Inc., 168 N.E. 521 (Mass. 1929); Lawson v. Household Fin.*Finance* Corp., 147 A. 312 (Del. Ch. 1929); Searles v. Bar Harbor Banking & Trust Co., 145 A. 391 (Me. 1929), Fopiano v. Italian Catholic Cemetery Ass'n, 156 N.E. 708 (Mass. 1927), Hassel v. Pohle, 214 A.D. 654 (N.Y. App. Div. 1925); Baumohl v. Goldstein, 124 A. 118 (N.J. Ch. 1924); Sterling Loan & Invest. Co. v. Litel, 223 P. 753 (Colo. 1924), Barrett v. King, 63 N.E. 934 (Mass. 1902).

[271] *Id.*

[272] Groves v. Prickett, 420 F.2d 1119,at 1122 (9th Cir. 1970) (citing Spencer v. Hibernia Bank, 9 Cal. Rptr. 867, 889 (Dist. Ct. App. 1960)), Tu-Vu Drive-In Corp. v. Ashkins, 391 P.2d 828, 830 (Cal. 1964) (en banc) (citing Spencer, 9 Cal Rptr. at 889), Sander Petroleum Corp. v. Williams, 321 S.W.2d 614, 617 (Tex. Civ. App. 1959).

[273] *See Colbert*, 217 N.E.2d at 920; *see also Baumohl*, 124 A. at 120-21, *Moses*, 63 Misc. at 209.

VII. COURT INTERPRETATION OF REASONABLE RESTRICTIONS IN ACTION

The courts have developed workable criteria for assessing whether or not to enforce the share transfer restrictions that are litigated before them. More particularly, these criteria implicate the assessment of the reasonableness of the specific share transfer restriction at issue. The courts have developed these criteria in light of policy underpinnings relating to the historical development of business organizations and their contribution to the overall needs of the business community. In the succeeding cases, restrictions on the transfer of stock have been individually scrutinized by the judiciary in order to determine their validity.

A. Voluntary Transfers

As indicated earlier, some restrictions on the transfer of stock have been held applicable to testamentary dispositions. The location of the restriction in the bylaws or in the articles of incorporation apparently has not been a determinative factor. Of course, the courts have usually concluded that, on the death of a stockholder, the involuntary transfer of the stock to the executor or executors is valid. This is legally viable because of the legal principles applicable to transfers by operation of law. Fundamentally, executors and administrators of estates - as successors in title to the pertinent decedents hold only legal title to the shares by virtue of the substantive provisions categorized as the operation of law. Equitable title resides temporarily in the estate until it is validly transferred to the designated beneficiaries under a valid will. In the event of intestacy, legal and equitable titles both devolve to the estate temporarily. It stays there until the ultimate recipients of the bounty of the decedent stockholder, under the legal rules of intestacy are identified. Once they are all identified, the rules of intestacy control the transfer of title to the property from the estate to the appropriate recipients.

These operations of law provisions serve as a legal device intended to promote certain efficiencies at common law. They facilitate the efficient, legally valid and prompt resolution of all legal and equitable matters pertaining to the decedent's estate. However, an executor of a deceased stockholder can inevitably have no greater rights in the stock than the decedent stockholder had while still alive. The executor therefore has rights equivalent

only to those that the decedent shareholder was legally and equitably entitled to exercise while alive. An executor is therefore subject to the same restrictions as those that were applicable to the decedent stockholder *inter vivos*.[274] This view would also seem to be in harmony with the rule of strict construction discussed below.

1. Strict Construction[275]

An examination of the rule or doctrine of strict construction is important. On completion of its overall examination, the court determines whether or not the specific corporate share transfer restriction is legally valid. The facts and circumstances of each particular case control the legal outcome.[276] A critical analysis of the facts and the decision in *Boston Safe Deposit & Trust Co. v. North Attleborough Chapter of American Red Cross*[277] is helpful in this respect.

In *Boston Safe Deposit & Trust Co.*,[278] the Supreme Judicial Court of Massachusetts, Bristol, held that executors of a deceased stockholder had no greater rights in the stock than did the testatrix.[279] Moreover, the executors were to hold the shares subject to the same restrictions on transfer that were in effect at the time of the testatrix's death.[280] The court noted that the executors were the present holders and could make the transfers in controversy. By operation of law, the title to the stock although specifically bequeathed vested in them upon their appointment. Once appointed, legal title passed to them by operation of law *notwithstanding the restriction*.[281]

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[274] Dixie Pipe Sales, Inc. v. Perry, 834 S.W.2d 491, 493 (Tex. App. 1992), Phillips v. McCullough, 663 N.E.2d 47, 53 (Ill. App. Ct. 1996).

[275] *See* FLETCHER, *supra* note 1, at § 5455 ("Courts applying common law principles have held that transfer restrictions constitute restraints on alienation and should be strictly construed. Under the rule of strict construction, the transfer restriction generally will be upheld if it is *reasonable and lawful*.") (emphasis added) (citations omitted).

[276] *See id.* ("The general test has been whether the restriction bears a reasonable relation to a valid corporate purpose.") (citation omitted); *See, e.g.*, Illinois ex rel. Rudaitis v. Galskis, 233 Ill.App. 414, 420 (Ill.App. Ct. 1924).

[277] Bos. Safe Deposit & Trust Co. v. N. Attleborough Chapter of Am. Red Cross, 111 N.E.2d 447 (Mass. 1953).

[278] *Bos. Safe Deposit & Trust*, 111 N.E.2d at 448.

[279] *Id.*

[280] *Id.*

[281] *Id.* at 449.

A competing contention needs to be discussed. The facts indicated that the restriction did not *specifically* refer to executors or administrators of the deceased stockholder. The competing contention was that, since there was no express reference to any executors or administrators it was therefore not binding or enforceable against the present executor. On the facts, the current executor had sought to transfer the stock to specific legatees in defiance of the share transfer restriction in issue.[282] This competing contention was judicially rejected.[283]

In rejecting the argument, the court reasoned that the language of the restriction was sufficiently clear and unambiguous. The share transfer restriction stated that it applied to *all* transfers of stock. Undeniably, the drafted language did not linguistically confine it to *inter vivos* stock transfers at all. On the contrary, the provision in controversy explicitly stated that transfers should be made upon the books of the corporation by the holder in person, or by an attorney duly authorized to make the transfer.[284] Clearly, the court got it right.

A later case also merits discussion. In *Colbert v. Hennessy*,[285] the Supreme Judicial Court of Massachusetts, Middlesex, reached a similar conclusion. The case dealt with the interpretation of a corporate bylaw. The bylaw included a provision requiring any stockholder, his heirs, assigns, executors, or administrators, who desired to sell or transfer stock to first offer the stock to the corporation. Additionally, the selling price had to be disclosed to the directors of the corporation in writing. The Supreme Judicial Court of Massachusetts, Middlesex, ruled that the language included in the bylaw must be interpreted as applicable to any and all purported transfers of the shares by the executor.[286] Such purported transfers of the stock were all subject to the express provisions of the corporate bylaw.[287] This was the case whether the purported transfers were to specific legatees of the stock or to any-

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[282] *Id.*
[283] *Id.*
[284] *Bos. Safe Deposit & Trust*, 111 N.E.2d at 449.
[285] *Colbert*, 217 N.E.2d at 921.
[286] *Id.*
[287] *Id.*

one else, for that matter.[288] Of course, the legatees and beneficiaries would inherit the proceeds of the stock.

2. Pledge of Stock

Pledges of stock are *not* usually *present transfers* of such stock. A pledge of stock is routinely a charge of the pledge stock as security for some accompanying valid transaction. Commercially, it is akin to a mortgage of the pledged stock, which then serves as security for the underlying transaction. For legal purposes, the pledge of stock itself is not usually defined as a present transfer of the stock that is pledged. For business purposes, the pledge is certainly not normally a present transfer at the time of the pledge either.

Monotype Composition Co. v. Kiernan,[289] is instructive. In *Monotype Composition*, the validity of a first option restriction was in issue. The first option was included in both the agreement of association as well as the bylaws of the particular corporation. The express language of the provision required shareholders wishing to "sell or transfer" stock to offer it first to the corporation.[290] The validity of the option was conceded, but its legal effect was not.[291] One contention relating to interpretation of the legal effect of the option was that it was restricted to a specific interpretation.[292] The specific interpretation contended for was that the express words "sell or transfer" stock did not apply to a *pledge* of stock.

Based upon the facts of the case, however, the pledge of stock was accompanied by a transfer signed by the stockholder.[293] The pledged stock was subsequently purported to have been sold at auction.[294] The lack of a challenge to the validity of the measure was ruled by the Supreme Judicial Court of Massachusetts, Suffolk, to be legally relevant and also significant.[295] The Court noted that the legal *validity* of the express restraint on alienation was not

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[288] *Id.*

[289] Monotype Composition Co. v. Kiernan, 66 N.E.2d 565, 567 (Mass. 1946).

[290] *Id.*

[291] *Id.*

[292] *Id.*

[293] *Id.*

[294] *Id.*

[295] *Monotype Composition*, 66 N.E.2d at 568.

challenged.[296] This being the case, the court ruled that the restriction was indeed binding upon the stock.[297] The court reasoned that the facts of the case were dispositive of the issues relating to the contentions presented.[298]

On the facts, the pledge was accompanied by a signed transfer in blank pertaining to the shares.[299] These specific facts controlled the legal outcome in the court's opinion. The Court therefore ruled that, in light of the facts of the case, the restriction was triggered.[300] The combination of the pledge with the signed transfer in blank justified the decision reached by the court. The court reasoned that the execution of the pledge when *combined* with the signed transfer in blank was legally indistinguishable from an attempted blatant transfer standing on its own.[301] Essentially, on the strength of the facts, the actual transaction in its entirety "was as repugnant to the agreement of association and the by-law as a transfer intended to be absolute and final would have been."[302]

3. Legal Impact of Size and Business Activity of the Corporation

Courts treat the size and business activity of the corporation as very significant factors in deciding whether or not the share transfer restriction is reasonable. These factors guide the court's decision in assessing whether or not to enforce the particular share transfer restriction at issue. As a result, analogy to the partnership plays a particularly significant role in the judiciary's thinking.[303]

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[296] *Id.*

[297] *Id.*

[298] *Id.*

[299] Albeit signed in blank.

[300] *Id.*at 568. *See supra* note 161. There must a trigger and it must be pulled.

[301] Monotype Composition, 66 N.E.2d at 568("It presented almost as great *a threat of interference by strangers* in the corporate affairs of the [corporation].... [I]t was [therefore] prohibited by the agreement of association and the by-law.") (emphasis added) (citation omitted).

[302] *Id.*

[303] *See, e.g.*, Lawson v. Household Finance Corp., 147 A. 312, 317 (Del. Ch. 1929) ("[T]he provisions of [share transfer restrictions] insert into corporate structure the characteristics of a partnership. An outstanding characteristic of a partnership, in so far as its economic advantages are concerned, is that its constituency is animated by a deep *personal interest* in its successful operation, and *efficiency in its conduct* is thereby calculated to be secured. That the plan adopted by this corporation ... is designed to reap the benefit of this sort of advantage, which is thought to inhere in a partnership, is plain.

Similar concepts also played a critical role in a much earlier case decided by the Supreme Court of Wisconsin, *Casper v. Katl-Zimmers Manufacturing Co.*[304]

In *Casper*, the Supreme Court of Wisconsin ruled that a provision in the corporation's articles of incorporation was legally valid.[305] The personal factors of trust and confidence in the personality characteristics of partners which are so overwhelmingly important in a partnership were treated by the court as particularly significant traits to foster in the corporation in controversy.[306] The court acknowledged their importance in reaching its decision.[307]

Moreover, as indicated earlier in this article,[308] the degree of skill and precision in drafting the particular provision can probably not be overstated. After all, the basis on which share transfer restrictions are enforced is a contractual one.[309] Therefore, individualized facts will be determinative in any given case. An earlier decision of the Court of Chancery of Delaware, New Castle County, in *Lawson v. Household Finance Corp*,[310] is helpful in this regard.

The Court of Chancery of Delaware, New Castle County emphasized the contractual nature of the corporation's articles in its decision.[311] Furthermore, in this instance, the corporation had

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There can be *no objection to that*, however. On the contrary, such a purpose is *manifestly commendable*. If it can be advanced consistently with the principle of corporate entity, no possible objection can be taken thereto.") (emphasis added).

[304] Casper v. Katl-Zimmers Mfg. Co., 149 N.W. 754 (Wis. 1914).

[305] *Id.* at 754. The provision gave the corporation an option to purchase any stock which the holders desired to sell.

[306] *Id.* at 756 ("The *personal element* is as important in the make-up and management of a corporation as it is in almost every other undertaking. Restrictions, therefore, reasonably protecting incorporators or stockholders in their interests[,] by permitting them first to purchase stock offered for sale, should be held lawful as promotive of good management and sound business enterprise.") (emphasis added).

[307] *Id.*

[308] *See supra* Part V.

[309] *See supra* note 114.

[310] *Lawson*, 147 A. 312.

[311] *Id.* at 315-16 ("A corporate charter is in one of its aspects a contract between the corporation and its stockholders and stock issued in accordance with charter provisions is held by the stockholder subject to all the lawful terms which the contract embodies . . . . [S]uch a provision as we are here considering is essentially of a contract nature and [is] one that parties may voluntarily accept ....") (citation omitted).

the right to deal in its own stock.[312] So, the purchase of its own stock did not pose a legal barrier to enforcement of the share transfer restriction.

However, it is conceded that some of the provisions in controversy were somewhat unusual.[313] For example, the provisions of the restriction required the sale of the stock at a price to be fixed by appraisers drawn from the body of interested stockholders.[314] Moreover, good will was not to be considered in fixing the value of the stock.[315] Nevertheless, the share transfer restriction *expressly* required a stockholder to afford the corporation an opportunity to purchase his stock before selling it to anyone else.[316] Therefore, since there was no proof of fraud or coercion on the facts, freedom of contract determined the legal outcome.[317] The court therefore held the particular share transfer restriction at issue to be reasonable and valid, and not at all contrary to public policy.[318]

B. Involuntary Transfers

Courts place testamentary dispositions in the class of involuntary transfers. Restrictions on the transfer of corporate stock have been held inapplicable to testamentary dispositions where interpretation of the drafted language required such a ruling. These courts have taken the view that, on principle, stock transfer restrictions are inapplicable to transmissions or devolutions of stock by operation of law.

1. Operation of Law[319]

Instances when corporate share transfer rights are activated and when they are not are separate and distinct. Voluntary action

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[312] *Id.* at 316 ("This corporation clearly ... had and has power to purchase its own stock").
[313] *Id.* at 316-17.
[314] *Id.*
[315] Id.
[316] *Id.*
[317] *See supra* note 114.
[318] *Lawson*, 147 A. 312.
[319] *See, e.g.*, Castonguay v. Castonguay, 306 N.W.2d 143, 145 (Minn. 1981) ("[A]ny restriction on transfer of stock must be explicitly worded.... [T]he general rule ... has long been that "involuntary transfers" are *not* included within a transfer restriction clause *unless the contrary conclusion is inescapable* ... [T]he settled majority rule ... may be summarized as follows: "(R)estrictions on the sale of corporate stock apply *only* to *voluntary sales*, and *not* to transfers by operation of law, *in the absence of a specific provision to that effect*.") (emphasis added) (citation omitted).

on the part of the pertinent stockholder and involuntary legal outcomes by operation of law must be actively distinguished. Stock transfers that are mandated by operation of law can be problematical. Such stock transfers may not be interpreted by the courts as legally valid triggers that activate the exercise of a particular share transfer restriction at all.[320] When stock transfers are mandated by operation of law, some first refusal rights in share transfer restrictions have been construed as inapplicable. In order to successfully invoke and exercise first refusal provisions in share transfer restrictions, it must be irrefutably proven that they apply to the facts in controversy. In some circumstances, based upon the drafted specifics of the express provisions included in such share transfer restriction rights, this proof did not materialize.

This failure is significantly attributable to a fundamental judicial conception. Stock transfer restrictions are perceived by the courts as being essentially applicable to *voluntary* sales contemplated by the stockholder.[321] Voluntary sales must be contrasted with transfers by operation of law. The judiciary has categorized testamentary transfers are *involuntary*. This means that in appropriate circumstances, such transfers will be immune to corporate share transfer restrictions altogether. So, a suggestion that drafting expertise retains its legal vitality in this context is the epitome of an understatement. Indeed, drafting expertise is elevated to the apex of significance.

Of course, testamentary dispositions represent a genre of transfer by operation of law. The concept of *operation of law* is a juridical phenomenon created by the genius of the common law. It is applicable in a number of contexts. In the context of a transfer of property by testamentary disposition as well as on intestacy, a number of transfers by operation of law apply. Under the common law, in these two specific contexts, such transfers by operation of law were conceptualized and created by the judiciary in order to eliminate interruptions in property ownership. These transfers by operation of law eliminate any hiatus in the ownership of property when an individual dies.

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[320] *See supra* note 161.

[321] Stern v. Stern, 146 F.2d 870, 870 (D.C. Cir. 1945); McDonald v. Farley & Loetscher. Mfg. Co., 283 N.W. 261, 263-64 (1939), Barrows v. National Rubber Co., 12 R.I. 173, 173 (1878).

For example, with respect to an individual, the first transfer of property by operation of law takes place on the individual's death. Instantaneously, at the time of death of an individual, legal and equitable titles to the decedent's property transfer without interruption. The transfer occurs legally and seamlessly to the decedent's estate by operation of law. This transfer to the estate of title to the decedent's property by operation of law occurs whether the decedent died testate or intestate. Of course, this does not mean that the estate owns the property absolutely and irrevocably in the sense of being entitled to consume and enjoy it. The estate holds title *temporarily* in accordance with the principles of the *operation of law* legal phenomenon. The estate's legal mandate is to hold and deal with the property in accordance with applicable operation of law obligations invented by the common law.

The applicable operation of law obligations are as follows. First, with regard to a testate death,[322] the validity of the will is determined by the common law legal mechanism of probate. If the will is validated by probate, by operation of law, any executor named in the will becomes legally empowered to dispose of the decedent's property in accordance with the provisions of the decedent's probated will.

Secondly, if the decedent died intestate,[323] somewhat similar legal principles apply. When an intestate death occurs, common law legal mechanisms ensure the appointment of an administrator. This administrator is appointed to perform functions similar to those performed by an executor in the event of a testate death. This means that, on appointment, the administrator is empowered to dispose of the decedent's property in accordance with applicable common law principles governing intestacy.

However, the operation of law obligations in instances of both a testate and an intestate death are similar in the sense that, when a testate death occurs, the executor is legally obligated to transfer the decedent's property in accordance with the terms of the decedent's valid will. This means that the executor must transfer any shares to which the will applies in accordance with the legally valid terms of the probated will.

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[322] *I.e.* where the decedent *has* left a will.

[323] *I.e.* where the decedent has *not* left a will.

In the event of an intestate death, the administrator must transfer the decedent's property in accordance with applicable common law rules governing intestacy. The applicable legal rules would require the administrator to transfer any corporate shares which were owned by the intestate at the time of death in accordance with those rules.

The principles support the following presumptive starting point. This starting point proposes that share transfer restrictions are presumptively *inapplicable* to the transfer of title to corporate shares by operation of law. Therefore, unless corporate share transfer restrictions are explicitly stated to supersede the provisions of a shareholder's will or to supersede the common law rules of intestacy[324] on a shareholder's death, corporate share transfer provisions do not apply to these transfers at all. There are *no* corporate share transfer restrictions that *presumptively* supersede the legal mandate of a decedent's will. This is clear.

Nor do corporate share transfer restrictions presumptively supersede the legal mandate of the rules of intestacy, which apply to the intestate succession to property. Hence, as pointed out earlier,[325] the language of a share transfer restriction must be drafted to expressly apply to testamentary dispositions or the rules of intestate succession to property in order to supersede them.[326]

As a result, in the absence of clearly and unambiguously drafted language, courts will not permit stock transfer restrictions to supersede directly and irreconcilably conflicting testamentary provisions or rules governing intestate succession to property. Of course, on proof of such conflict, the share transfer restrictions will not necessarily be legally nullified in their entirety. Instead, the judiciary will grant the testamentary provisions and intestacy rules of succession to property rules immunity from the application of share transfer restrictions.

Undeniably, therefore, share transfer restrictions do not apply to transfers by operation of law in the absence of a specific and unambiguous provision making them so applicable.[327] However,

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[324] Where legally permissible.

[325] *See supra* Part V subpart 1. Drafting.

[326] *Id.*

[327] London, Paris & Am. Bank, Ltd. v. Aronstein, 117 F. 601, 609 (9th Cir. 1902), Stern v. Stern, 146 F.2d 870 (D.C. Cir. 1945).

the recipient of shares under the decedent's will is subject to a different legal mandate. This is the case because the recipient of the shares under the decedent's will takes title *as is*.[328] This means that any future transfer by the recipient[329] of the shares is subjected to the full legal force of any valid share transfer restrictions which encumber the pertinent stock.[330] It is also legally accurate to propose that any future recipients are also bound by valid share transfer restrictions in any future transfer of the shares as well.[331]

The early case of *Stern v. Stern*[332] supports this analytical framework and its conclusions. In *Stern*, the United States Court of Appeals for the District of Columbia clarified the distinction between the concepts of voluntary and involuntary disposition. In *Stern*, the bylaw enunciated that stock should first be offered to the corporation and then to the stockholders before it could be validly transferred to outsiders. The bylaw did not expressly state that it applied to testamentary dispositions at all. The court ruled that the share transfer restriction meant that the stockholder must make the specified offers prior to the *voluntary* transfer of the stock. Of course, it can be conceded that the language of the bylaw implicated the making of a choice by the stockholder. Furthermore, the making of a will is a voluntary act. It implicates the making of a choice or choices by the testator as to who will receive his property on his death.

However, the court clearly accepted that a disposition by will is a form of involuntary transfer.[333] This is rational because no transfer of title to the property occurs when a will is made. On the contrary, when a will is made title remains vested in the testator until his death. So, whereas the *making* of a will is voluntary, the actual transfer or disposition of the property to which the will ap-

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[328] I.e., Under the terms of the decedent's will, the recipient of the shares inherits the *decedent's title* to the shares. That title is inherited by the recipient still encumbered by all valid share transfer restrictions that applied to the shares when owned by the decedent prior to her or his death.

[329] Whether the recipient is the heir, legatee, or assignee.

[330] *Lehtinen*, 788 N.E.2d at 1084, *Kerr*, 889 P.2d at 874-75, *Phillips*, 354 S.E.2d at 323-24, *Colbert*, 217 N.E.2d at 921, *Bos. Safe Deposit & Trust Co.*, 111 N.E.2d at 449.

[331] *Kerr*, 889 P.2d at 875, *Colbert*, 217 N.E.2d at 921, *Bos. Safe Deposit & Trust Co.*, 111 N.E.2d at 449.

[332] 146 F.2d 870.

[333] *See id.*

plies is effected by the testator's death.[334] This is indisputable and makes the transfer by will an involuntary transfer because of the common law's operation of law conceptions.

The court therefore distinguished the legal difference between application and non-application of the bylaw by focusing on the legal distinction between voluntary and involuntary transfers mattered in this respect. The court interpreted the specific bylaw language "before the stock may be transferred" to mean that the stockholder had to make the offers – required by the bylaw - *before* the stockholder was legally free to *voluntarily* transfer the specific stock free of the encumbrance of the bylaw.[335] This interpretation was selected rather than the competing determination that the stockholder had to make such offers prior to his death.

Therefore, the court held that the bylaw did not apply to the situation that would arise when – based upon the stockholder's death transmission or devolution was mandatory by operation of law.[336] The court did not reason that the stockholder was obligated to make and complete the transfers *prior* to death. The court concluded that the bylaw was applicable to certain specific situations.[337] These specific situations did not include instances when as a result of the stockholder's death – mandatory transmission or devolution of the relevant shares became inevitable by the activation of the *operation of law* doctrine.[338]

Taylor's Administrator v. Taylor[339] accepted the above analysis as legally valid. In *Taylor*, the Court of Appeals of Kentucky analyzed a bylaw that provided that no transfer or sale of the stock of the corporation could be made without first offering the stock for sale to the stockholders.[340] The restriction did not explicitly mandate applicability to disposition by will.[341] There was no reference at all to disposition upon a shareholder's death.[342] Fur-

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[334] *See id.* at 870 (D.C. 1945) ("The by-law does not apply to the situation which arises when, because of a stockholder's death, transmission or [devolution] of his shares is inevitable.").

[335] *Stern*, 146 F.2d at 870.

[336] *Id.*

[337] *Id.*

[338] *Id.*

[339] *Taylor's Adm'r*, 301 S.W.2d 579.

[340] *Id.* at 581-82.

[341] *Id.*

[342] *Id.* at 583.

thermore, a conclusion as to whether or not this was the stockholder's *subjective* intention would be a foray into speculation. No facts supported such a factual finding. Applicability to testamentary dispositions required express or implied inclusion of such a mandate within the terms of the bylaw itself.[343] There was no such inclusion.[344] Additionally, the court interpreted the drafted language of the share transfer restriction as requiring proof of a sale of stock.[345] However, no such proof of a sale was presented.[346] The Court therefore ruled the share transfer restriction inapplicable.[347]

In the Matter of Riggs' Estate[348] is also particularly helpful in this regard. In *Matter of Riggs' Estate*, the Colorado Court of Appeals, Div. I reversed the court below and ruled that a restriction on the sale of corporate stock did not apply to a bequest by the decedent of her shares to her son.[349] The Colorado Court of Appeals, Division I reversed the court below because the share transfer restrictions in controversy did not specifically state that they were applicable to testamentary dispositions.[350] This meant that the corporation was *not* legally empowered to be granted a court order requiring the executor of the deceased shareholder to transfer the shares to the corporation. On the contrary, the executor was legally required to act in accordance with the terms of the decedent's will.[351] The provisions of the will superseded the share transfer restrictions.[352] This is the case because, in the absence of specific provisions, testamentary dispositions are immune to the provisions of share transfer restrictions.[353]

Of course, however, the beneficiary of the shares is not in the same legal position as the executor who transferred the shares

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[343] *See id.*

[344] *Id.* at 583.

[345] *Taylor's Adm'r.*, 301 S.W.2d at 582 ("The terms of the bylaw are that 'no transfer or sale of the stock of the company can be made without first offering said stock for sale to the stockholders.'").

[346] *Id.* ("*There has been no sale.* Title passed by operation of law and the will of the shareholder.") (emphasis added).

[347] *Id.* at 584.

[348] 540 P.2d 361 (Colo. App. 1975).

[349] *Id.* at 363.

[350] *Id.*

[351] *Id.*

[352] *Id.*

[353] *Id.*

to the beneficiary. The ownership of the beneficiary is controlled by legal obligations that differ from those applicable to the executor who transferred the pertinent shares to the beneficiary. The beneficiary inherits the shares under the will with the share transfer restrictions attached. The legal obligations imposed upon the beneficiary under the share transfer restrictions are identical to those imposed upon the testator while alive. Therefore any future transfer by the beneficiary of the particular shares subjects the beneficiary to the full force of the legal mandate of the share transfer restrictions. These legal obligations apply because the beneficiary of the shares stands in the shoes of decedent shareholder.[354]

Moreover, this legal reasoning was more recently reinforced by the Supreme Court of Illinois in *Roth v. Opiela*.[355] In *Roth*, the share transfer restrictions did not explicitly include transfer by intestate succession within their terms of applicability.[356] The restrictions were therefore not triggered[357] by intestate succession. The Supreme Court of Illinois reiterated the legal distinctions between the conscious voluntary acts of an individual and the involuntary legal effect of the rules of intestacy.[358]

On the facts of the case, the Court ruled that stock owned by a shareholder who died intestate devolved by operation of law to certain recipients.[359] These recipients received title to the property as mandated under the particular state's common law rules of intestacy.[360] Devolution by operation of law is not legally synonymous with bequeathing property under the terms of a will.[361] Nor is it legally the functional equivalent of "otherwise giving"[362] the property to recipients who take by intestate succession. These legal distinctions were conclusive on the facts in controversy. Devolution under the rules of intestacy is neither bequeathing nor oth-

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[354] *In re Riggs' Estate*, 540 P.2d at 363.

[355] Roth v. Opiela, 813 N.E.2d 114 (Ill. 2004).

[356] *Id.* at 117-18.

[357] *See supra* note 161.

[358] *Roth*, 813 N.E.2d at 119.

[359] *Id.*

[360] *Id.* at 119.

[361] *Id.* at 118 ("[W]ords [such as] 'specifically bequeathed' [are] words which connote *an affirmative action taken on the part of the original shareholder*.") (emphasis added).

[362] *Id.* at 119 ("[I]t is appropriate to give the words 'otherwise given' their plain and ordinary meaning and to assume that the words refer to *some affirmative act of transfer*, such as an *inter vivos* gift.") (emphasis added).

erwise giving. Bequeathing and giving are human acts. Devolution by intestacy occurs where a decedent has declined to bequeath or to give. Devolution by intestacy is a function of an act of divine intervention.

The Court therefore ruled that the corporation's right to repurchase the stock on the shareholder's death was neither expressly nor impliedly included within the drafted language of the pertinent share transfer restrictions. Irrefutably, intestacy cannot legally qualify as a *conscious* act of giving.[363] Nor is it an act of bequeathing. This decision makes sense. The conception of volition cannot rationally include an *operation of law* effect. These two concepts are mutually exclusive.

2. Strict Construction of the rule of reasonableness

The express terms of a number of provisions may purport to restrict transfers or sales of any kind whatsoever. This is the case whether the transfers or sales are voluntary or involuntary. Such absolute restrictive provisions are null and void.[364] Of course, the term "transfer" is more legally extensive in coverage than the word "sale." The term "transfer" inescapably means *a change in ownership*.[365] Therefore, where the restriction explicitly applies only to the term "sale" or "right to sell," or equivalent provisions, such restrictions are very narrowly construed. They are more narrowly construed than the term "transfer." The terms sale or right to sell are generally construed to apply only to *voluntary* "sales" and *not* to all "transfers."

In the context of the more expansive term "transfers," *Globe Slicing Machine Co. v. Hasner*[366] is helpful. This decision articulates a more particular judicial approach. In *Globe Slicing Machine Co.*, the Second Circuit construed a bylaw that prohibited the sale or disposition of shares of stock without first giving the corporation or its stockholders an opportunity to purchase them.[367]

The court ruled that testamentary disposition of stock were excluded.[368] The court reasoned that any application to testamen-

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[363] *Id.*

[364] *See supra* note 16.

[365] In re Estate of Garvin, 6 A.2d 796, 800 (Pa. 1939).

[366] Globe Slicing Mach. Co. v. Hasner, 333 F.2d 413 (2d Cir. 1964).

[367] *Id.* at 414.

[368] *Id.*

tary dispositions must be clearly and unambiguously indicated or justified by judicial detection of such an implication.[369] The court emphasized that the public policy of the State of New York is to construe first option restraints narrowly and with circumspection.[370] This meant that such provisions, in order to effectively restrain disposition by testamentary transfer, must *explicitly* refer to such transfers.[371]

In the same vein, much earlier, the stage was set for decisions such as *Globe Slicing Machine Co.*[372]by the Wisconsin Supreme Court in *In Re Magnetic Manufacturing Co.*[373] In *Magnetic Manufacturing Co.*, the court construed the pertinent bylaw as follows. First, the bylaw required a stockholder, desiring to sell stock, to first offer the pertinent stock to the corporation.[374] Second, the offer to the corporation had to be at as low a price as the stockholder would sell to any person.[375]

Additionally, it provided that no stock shall be transferred except upon compliance with such requirement. [376] The court restricted the bylaw exclusively to *voluntary* sales.[377] The court ruled that use of the term "transfers" in the latter part of the bylaw, by necessary implication, must be restricted to transfers *incident* to sales.[378] The bylaw had explicitly referred to "sales" earlier in its provisions.[379] This earlier reference to "sales" irrefutably restricted the meaning of "transfers" when used later in the bylaw.[380] The court was not persuaded that the more extensive meaning of the term "transfer" was objectively intended.[381] In all fairness, the terms could have been coordinated if the drafter of the bylaw had elected to do so. Thus, the more extensive meaning was precluded by the antecedent use of "sales" rather than "transfers."

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[369] *Id.* at 415.
[370] *Id.*
[371] *See id.*
[372] Globe Slicing Mach. Co. v. Hasner, 333 F.2d at 414.
[373] In re Magnetic Mfg. Co., 229 N.W. 544, 545 (Wis. 1930).
[374] *See id.* at 545.
[375] *See id.*
[376] *See id.*
[377] *See id.*
[378] *Id.*
[379] *See In re Magnetic Mfg. Co.*, 229 N.W. at 545.
[380] *See id.*
[381] *Id.*

Vogel v. Melish[382] is in accord. In *Vogel*, the Supreme Court of Illinois interpreted a stockholders' agreement.[383] The agreement provided that if either party to the agreement desired to sell[384] all or a part of the pertinent shares, the stockholder must first offer such shares to the other stockholders.[385] The court decided that the provision terminated on the death of the stockholder.[386] The court so held notwithstanding the specific wording of the provision. The explicit language in the restriction stated that it was binding upon and inured to the benefit of the parties.[387] However, it also referred to the respective executors, heirs, and personal representatives of the parties.[388] Arguably, therefore, it purported to impose identical requirements upon the administrators of the pertinent parties as well.[389]

Nevertheless, the court concluded that the wording of the provision was too amorphous to be interpreted so extensively.[390] In the court's opinion, in order to embrace all transfers by necessary implication, more precise language was necessary.[391] The court retained its focus on the following fundamental premise. Irrefutably, provisions that restrain the alienation of corporate shares are to be *strictly* construed.[392] The Illinois Supreme Court affirmed the Appeals Court for the First District, and thus affirmed the trial court's conclusions as valid.

The trial court had perceived no *express* inclusion of an unambiguous restriction on intestate or testamentary disposition within the terms of the provision in controversy. The Illinois Supreme Court agreed. By virtue of the rule of *strict* construction, the bur-

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[382] Vogel v. Melish, 203 N.E.2d 411 (Ill. 1965).

[383] *See id.*

[384] *See id.* at 413 ("[T]he agreement recit[ed] 'sell, transfer, assign, convey or otherwise dispose of;' [however] there is no express restriction on intestate or testamentary disposition, and under the rule of strict construction, none can be implied.").

[385] *Id.* at 412.

[386] *See id.* at 413, *see also supra* note 142 and the accompanying discussion of specific language used by the drafting parties. *But see Dominick*, 367 S.E.2d 487.

[387] *Vogel*, 203 N.E. 2d at 414.

[388] *Id.* at 413-14.

[389] *See id.* at 413-14.

[390] *Id.* at 414.

[391] *See id.*

[392] *See supra* note 139 and the accompanying discussion.

den of proof to override this premise was not sustained. Any implication of such a restriction was therefore obviated.[393]

Finally, *Estate of Martin* brought down the curtain.[394] In *Estate of Martin*, a bylaw of a closely held family corporation was in issue. The Arizona Court of Appeals applied careful and cautious scrutiny. Actually, the bylaw provided that no stock in the corporation could be issued,[395] to any person who was not a blood relative of the founders. The pertinent bylaw, however, mandated a specific exception. The specifics of this exception required the unambiguous approval of the board of directors. The court therefore held the bylaw inapplicable to testamentary dispositions.[396]

In fact, the will of the decedent stockholder made no specific reference to the disposition of the decedent's shares of stock at all. Actually, the will bequeathed all of the rest[397] of the estate[398] to specified trustees for charitable uses.[399] The decedent's progeny asserted that the decedent's will violated the terms of the corporation's bylaws. This assertion was essentially that bequeathing the stock to other than blood descendants violated the corporate bylaw. This alleged violation purportedly nullified the provisions of the decedent's will, which sought to devolve the remainder of the estate to charitable uses.

The descendants of the decedent therefore requested that the court specifically enforce the bylaw restriction.[400] They urged the court to invoke its equitable discretion[401] in this regard and thereby grant specific enforcement of the bylaw restrictions.[402] In essence, they urged the court to exercise its equitable discretion in their *own* favor and thus judicially order the executor to convey the

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[393] *Vogel*, 203 N.E.2d at 413-14.

[394] In re Estate of Martin, 490 P.2d 14, 15 (Ariz. App. 1971) ("The *pivotal* question is whether the by-law restriction on alienability applies to a *testamentary* disposition.") (emphasis added).

[395] "Transferred, sold, or hypothecated . . . ." *Id.*

[396] *Id.*

[397] *I.e.* "residue, and remainder "

[398] Including "real, personal, and mixed, of whatsoever kind and description . . . ." *Id.*

[399] *Id.*

[400] *Id.*

[401] *In re Estate of Martin*, 490 P.2d at 15.

[402] *Id.*

stock to them. These assertions were purportedly in *harmony* with at least the *spirit* of the bylaw's provisions.[403]

Furthermore, the descendants did not "put all their eggs in one basket." They tactically bifurcated their strategy. They argued that, alternatively, the court's equitable jurisdiction should be exercised in their favor to declare that the decedent died partially intestate with respect to their shares of stock.[404] This alternative argument inevitably required a court determination that a partial intestacy was legally irrefutable. By virtue of this interpretation, the trial court's decision in favor of the descendants would be fully vindicated. This interpretation unavoidably required a judicial conclusion that it was the decedent's intent that the stock remain in the family.[405]

Division 2 of the Court of Appeals of Arizona reversed the trial court's decision.[406] The Arizona Court of Appeals concluded that the language of the will "clear[ly] and unequivocally manifest[ed] [the decedent's] intent to dispose of *all* of his property."[407] The court was not persuaded by the arguments in favor of a *partial* intestacy ruling.[408] The Arizona Court of Appeals reiterated that restrictive provisions are strictly construed.[409] The Arizona Court of Appeals further enunciated that "in this jurisdiction we prefer construction of a will *favoring testacy* over intestacy."[410]

The Arizona Court of Appeals detected no *explicit* restriction on testamentary disposition in the pertinent corporate bylaw. As a result, the Arizona Court of Appeals held that in light of the absence of such an *express* restriction on testamentary disposi-

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[403] *Id*

[404] *Id.* at 15.

[405] *Actually* (subjectively) or in the alternative *reasonably* (objectively).

[406] *Id.*

[407] *Id.* at 16 (emphasis added).

[408] *In re Estate of Martin*, 490 P.2d at 16 ("The trial court *improperly* indulged in a construction leading to a partial intestacy and looking *beyond the terms of the will in search of a contravening intent.*") (emphasis added).

[409] *Id.* at 15 ("Restrictions on the alienation or transfer of corporate stock are *not looked upon with favor*; they are sustained as valid provided they are *authorized* and reasonable. However, such restrictive provisions are *strictly construed.*") (emphasis added) (citations omitted).

[410] *Id.* at 16 (emphasis added).

tion in the bylaws, the rule of strict construction effectively precluded such a restriction by necessary judicial implication.[411]

3. Pledge of Stock

Restrictions on the alienation or transfer of corporate stock generally apply to *sales* of such stock.[412] There is no natural application of such provisions to a *pledge* of stock. Logically, a well-drafted share transfer restriction could be activated by the pledge of a stock. However, the admonition to draft clearly and unambiguously remains. This conclusion is rationally consistent since, on principle, a pledge of stock does not transfer title to the property that the pledged-stock reflects.[413] Of course, it must be immediately conceded that a failure to meet the contractual terms of redemption of the pledge routinely incurs consequences. Specific provisions that are an integral component of the pledge agreement ordinarily trigger the potential loss of ownership. In appropriate circumstances, such express provisions could inevitably lead to mandatory transfer of title to the stock if redemption obligations relating to the pledge are not met.

The legal theory of the validity of the adoption of specific bylaws by the board of directors of the corporation at its organizational meeting can apply.[414] In appropriate circumstances, legal conceptions that the specific objective of preventing the disposition of stock to strangers can arguably be vindicated.[415] However, prohibiting the transfer of all pledged stock without first giving the corporation or its members the opportunity of purchasing such stock at an equal price can be problematic. The acuity in drafting that applies to share transfer restrictions of stock generally is equally applicable to such circumstances.[416]

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[411] *Id.* ("We hold that since there is *no express restriction on testamentary disposition* in the present case the rule of strict construction inhibits such restriction by implication.") (emphasis added).

[412] *I.e.*, a transfer of *title to the stock* must be implicated.

[413] *Shanks*, 73 N.E.2d at 98-99, Good Fellows Assocs. v. Silverman, 186 N.E. 48, 50 (Mass. 1933), Crescent City Seltzer & Mineral Water Mfg. Co. v. Deblieux, 3 So. 726, 727 (La. 1888).

[414] *See* MBCA, *supra* note 7.

[415] *See supra* note 2.

[416] *See supra* note 140 and accompanying discussion.

Clearly drafted provisions will be enforced.[417] For example, share transfer restrictions could be crafted that empower the making of an offer[418] by a stockholder to pledge owned-stock to a non-shareholder to activate a right to buy the pledging stockholders shares at a stated reasonable price. Similarly, an attempt by a non-shareholder pledgee to become a stockholder in place of the original stockholder who initially pledged the relevant stock would depend upon the terms of any corporate share transfer restriction. The attempt to effect a change in stockholder identity would be caused by the pledgee's attempt to buy the pledged stock and thereby become the new owner of such stock. *Some* courts will wait until this is attempted by the pledgee before interpreting the specific provisions of any share transfer restriction.[419]

However, for the duration of the pledge, a pledge of stock is *not* a transfer of title to the stock that is pledged.[420] Therefore, unless expressly stated in the share transfer restriction, a pledge of stock will not ordinarily trigger the application of a share transfer restriction.[421] The act of pledging the stock was not expressly within the charter provision as drafted.[422] An express right giving the corporation, or on its default, any one or more of its members, the privilege of purchasing a *selling* shareholder's stock at the price offered or at its market value is not synonymous with a *pledge* of such stock at all.[423]

4. Other Specific Operation of Law Contexts

This segment analyzes and discusses the legal impact of share transfer restrictions on some additional specific instances of involuntary transfers of stock by operation of law. The applicable legal principles isolated and presented earlier in this article similar-

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[417] *Id.*

[418] Or the acceptance, by a stockholder as pledgor, of an offer to the stockholder by a non-shareholder pledgee.

[419] *See, e.g.*, Crescent City Seltzer & Mineral Water Mfg. Co. v. Debliex, 3 So. 726, 727 (La. 1888) ("When [the pledgee] shall seek to enforce his pledge by sale and transfer of the [pledged] stock it will be time enough to discuss the effect of [the stock transfer] provision and the corporation's right thereunder to claim [enforcement of the stock transfer *to the corporation* rather than to the pledgee].").

[420] *See id.* ("[The original stockholder] remains the owner [of the pledged stock].").

[421] *Id.*

[422] *Id.*

[423] *Id.*

ly apply to these examples of transfers by operation of law as well. The relevance of the drafted language of the share transfer restriction in issue is reinforced. Its drafted provisions are dispositive.

i. Divorce and Marriage Dissolution

A helpful example is *Castonguay v. Castonguay*.[424] In *Castonguay*, the Supreme Court of Minnesota helpfully identified the legal nature of transfers of stock ordered by a court in a marriage dissolution proceeding.[425] The court declared that a stock transfer ordered by a court is a transfer by operation of law.[426] Additionally, the court acknowledged that such transfers *can* activate share transfer restrictions.[427] This means that corporate share transfer restrictions *can* be drafted to apply to stock transfers by operation of law.[428] The particular share transfer restriction must be clearly and unambiguously drafted in order to accomplish such activation.[429] This makes the drafted language of any pertinent share transfer restriction the critical starting point of each judicial determination.[430]

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[424] 306 N.W.2d 143 (Minn. 1981); *accord,* Durkee v. Durkee-Mower, Inc., 428 N.E.2d 139, 143 (Mass. 1981) ("[T]he Probate Court's transfer order, by operation of law, is not subject to the restriction."), In re Devick, 735 N.E.2d 153, 162 (Ill. App. Ct. 2000) ("We determine that the restriction is applicable only to voluntary transfers and not to transfers by operation of law, such as by court order."), Earthman's, Inc. v. Earthman, 526 S.W.2d 192, 202 (Tex. Civ. App. 1975) ("We hold that the trial court properly determined that this provision did not afford to the corporation the right or option to purchase the shares . "). Similarly, under Louisiana Code Provisions, Messersmith v. Messersmith, 86 So.2d 169, 173 (La. 1956) ("The restriction in the [corporation's] charter cannot affect the status of the stock . . . .").

[425] *Castonguay,* 306 N.W.2d at 146 ("[A] transfer of stock ordered by the court in a marriage dissolution proceeding is an involuntary transfer not prohibited under a corporation's general restriction against transfers unless the restriction *expressly prohibits involuntary transfers*.") (emphasis added).

[426] *Id.*

[427] *Id.* ("[The] option repurchase rights under Article VII of the corporation's articles of incorporation ... *could have been validly created,* but, [they were] *not.*") (emphasis added).

[428] *Id.*

[429] *See id.* at 145-46.

[430] *See id.* (The drafted language of the share transfer restriction in *Castonguay* was interpreted as falling short of specifically including transfers by operation of law within its mandate.).

Since transfers by operation of law are involuntary,[431] such transfers presumptively escape the application of share transfer restrictions. Undeniably, the fundamental basis for such a conclusion is the fact that such a transfer in a marriage dissolution proceeding is judicially mandated.[432] It is therefore not voluntary. Judicial compulsion makes such transfers profoundly different from voluntary transfers by a shareholder. Voluntary transfers by shareholders are a function of private decisions and the exercise of private party autonomy. Judicially mandated transfers are not identical to such transfers at all.

Moreover, the starkness of the difference is reflected in the difference in value of the shares under one when compared with the other. Under the express terms of the share transfer restriction in issue, any shares transferred had to be valued at book value.[433] The book value mandated by the share transfer restriction was the historical purchase price.[434] In contrast, immunizing the actual transfer of the shares from the application of the share transfer restriction made the shares subject to a court-ordered valuation.[435] This meant a reasonable valuation based upon the market value of the property owned by the corporation.[436] The valuation of the shares in issue under this method was quite different from the book value.[437] It was significantly higher.[438] Clearly, the court concluded that the higher value was fair and equitable. This was a transfer by operation of law, which made judicial value-judgments the dispositive mechanism rather than the particular share transfer restriction in issue.

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[431] *See supra* note 399.

[432] *Castonguay*, 306 N.W.2d at 145.

[433] *Id.* ("[T]he weight of authority decidedly supports the ... conclusion that the trustee in bankruptcy ... had the right and obligation to sell the stock for the best price obtainable.").

[434] *See id.* (This amounted to $52,390.56).

[435] *See generally id. I.e.* a reasonable valuation objectively determined by appraisal would be typical.

[436] *Id.* at 144-45(The corporation owned real estate, which it held for development and sale.).

[437] *Id.* at 145.

[438] *Castonguay*, 306 N.W.2d at 145 (It was $149,029 representing a difference of $96,638.44.).

ii. Bankruptcy

The second example clarifies the legal impact of a corporate share transfer restriction on the freedom of a trustee in bankruptcy's right to sell and transfer a bankrupt's stock.[439] The question in controversy related to the legal potency of a trustee in bankruptcy's rights when disposing of the bankrupt's stock.[440] *In re Trilling & Montague*[441] unequivocally indicates that a trustee in bankruptcy is presumptively free to seek the best price reasonably obtainable for the stock in issue.[442] A transfer of corporate stock by a trustee in bankruptcy is a transfer by operation of law and therefore involuntary.[443] The trustee's obligation is to obtain the best price reasonably possible in the interests of the creditors of the bankrupt. Public policy fundamentals support unshackling the trustee from share transfer restrictions which limit the trustee's freedom to perform the legally mandatory obligations of such trustee's appointment.

The presumption that a transfer by the trustee in bankruptcy falls outside the reach of a corporate share transfer restriction is a rebuttable one.[444] However, the language necessary to rebut the presumption must be cataclysmically clear.[445] The language, which is drafted to attain this outcome, must make the annihilation of the presumption an inescapable interpretation of the restriction in controversy.[446] The operative language of the share transfer restriction in issue in the case of *In re Trilling & Montague* failed to do so.[447] The presumption was not rebutted.[448]

iii. Insolvency

The third example implicates a sale of particular stock by the receiver of an insolvent stockholder.[449] Similarly to a trustee in

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[439] *In re Trilling & Montague*, 140 F.Supp. at 261.
[440] *Id.*
[441] *Id.*
[442] *Id.*
[443] *Id.*
[444] *Id.*
[445] *In re Trilling & Montague*, 140 F.Supp. at 261.
[446] *Id.*
[447] *Id.*
[448] *Id.*
[449] McDonald v. Farley & Loetscher Mfg. Co., 283 N.W. 261, 265 (Iowa 1939).

bankruptcy, a receiver of an insolvent party is under a legal obligation to obtain the best price reasonably possible. This best price reasonably obtainable is legally mandated in the interests of the creditors of the insolvent party. Public policy fundamentals applicable to the trustee in bankruptcy also circumscribe the receiver's efforts in the interests of the insolvent party's creditors. In the vintage case of *McDonald v. Farley & Loetscher Mfg. Co.*, the Supreme Court of Iowa enunciated the fundamental principles that apply to corporate share transfers by operation of law.[450]

The Court clarified the existence of the presumption that share transfer restrictions are presumptively inapplicable to transfers by operation of law. The Court established that transfers by operation of law are involuntary. This legal status puts them presumptively beyond the reach of share transfer restrictions. This is the case because share transfer restrictions *presumptively* apply to voluntary transfers *only*.[451]

Only proof that the drafted language of the pertinent restriction is transcendently and unambiguously clear will be sufficient to include transfers by operation of law within its provisions. Each particular share transfer restriction is strictly construed. The burden of proof to establish that a particular share transfer restriction applies to involuntary transfers is the antithesis of easy and straightforward. It is a heavy burden of proof. The language included in the share transfer restriction in *McDonald* did not successfully meet that burden of proof.

VIII. CONCLUSION

Influenced by pivotal turning points,[452] judicial attitudes develop over time and evolve into legal norms.[453] Analysis, evalu-

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[450] *Id.* at 265 ("We are of the opinion that the [same] rule that restrictions ... apply only to voluntary sales and do not apply to transfers by operation of law in the absence of a specific provision is [also] applicable to restrictions on the sale of corporate stock.") .

[451] *Id.*

[452] *See, e.g., supra* note 47 and accompanying discussion of the initial and continuing impact of Chief Justice Holmes opinion in Barrett v. King, 63 N.E. 934 (1902).

[453] *See, e.g.*, Justice Anthony M. Kennedy, Interview, 13 SCRIBES J. OF LEGAL WRITING 79, 84 (2010) ("[As a judge] you have various purposes in writing opinions ... You must convince the parties that you've understood their arguments. You must convince the attorneys that you've understood the law. And if it's a case of public importance, you have a different and *much more difficult objective*. You must command allegiance to

ation, and synthesis of legally valid share transfer restrictions have confirmed that such restrictions are not exceptions to these principles. Rather, completion of the exercise has validated these phenomena. In this regard, absolute prohibitions on corporate share transfer restrictions have come and gone. Of course, absolute barriers to corporate share transfers never garnered judicial support in the first place. They did not succeed in becoming legally valid at all.

In contrast, share transfer restrictions were born and survived. They continue to do so today. In this respect, Chief Justice Holmes' immortal decision in *Barrett v. King* [454] irretrievably consigned share transfer restrictions in close corporations to legal survival. The decision has served as a cornerstone of the modern judicial philosophy pertaining to share transfer restrictions. An investigation of their legal history has corroborated this. The decision has assured the future success of the ubiquitous presence of these restrictions in the corporate documents of close corporations that is witnessed today.

Under examination in the crucible of judicial scrutiny, their validity metamorphosed from negative to positive dimensions. Their evolution took this course because their enforcement by the judiciary promotes defensible goals of the stockholders who create them. Drafters of share transfer restrictions must say what they mean. The judiciary is not opposed to enforcement of share transfer restrictions provided that the criteria, which it has carefully and incrementally developed, are met. These judicially developed criteria assess the reasonableness[455] of each specific share transfer restriction under scrutiny.

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your opinion. You must *command allegiance to the judgment of the Court. This is the common law tradition.*") (emphasis added) *See also* BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS, 178 (1963) ("The work of a judge is in one sense enduring and in another sense ephemeral. What is good in it endures. What is erroneous is pretty sure to perish. *The good remains the foundation on which new structures will be built.* The bad will be rejected and cast off in the laboratory of the years.") (emphasis added).

[454] Barrett v. King, 63 N.E. 934 (1902); *see supra* note 296.

[455] *See, e.g.*, VICTOR E. FRANKL, MAN'S SEARCH FOR MEANING at 146 (1959) ("[Certain] values, however, cannot be espoused and adopted by us [merely] at a conscious level – they are something that we *are*. They have crystallized in the course of the evolution of our species, they are founded on our biological past and are rooted in our biological depth.").

There is an additional critical element in the equation of judicial validation and enforcement. It is the judiciary's perception that the enforcement of share transfer restrictions in close corporations resonates harmoniously with its own evaluation of discreet policy underpinnings. These particular policy underpinnings emanate from the judiciary's awareness of the development of business organizations of the scope and nature of close corporations. Share transfer restrictions play a fundamental role in the development of trust and the retention of confidence in the functioning of the internal structures of close corporations.

Share transfer restrictions have therefore evolved admirably. The ultimate judicial resolution of the conflicting legal forces implicated by the creation and use of corporate share transfer restrictions is a workable one. This resolution harmonizes and accommodates certain antithetical forces and competing commercial factors. As corporate law currently stands, the antithetical forces of freedom of alienation and restraint on alienation are balanced by the judiciary.[456] Courts balance nullification and permissible restriction in a judicially tolerable equilibrium.[457] As a result, corporate share transfer restrictions have now become firmly integrated into the legal firmament of American corporate culture.[458] Arguably, share transfer restrictions constitute one of those "conceptual treasures" as defined by Professor Marvin Minsky.[459] They are here to stay.

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[456] *See Witte*, 715 S.W.2d at 291 ("[The] disposition to favor free transfer over restricted transfer transposes into the principle of construction that agreements to restrict transfer of shares are given effect according to the actual terms of limitation, and *not beyond*. That is to say, the manifest intention of the contractors *is confined to the plain meaning of the terms of restriction employed*.") (emphasis added) (citation omitted).

[457] *Id.*

[458] Culture has been defined as follows by one commentator. *See* MARVIN MINSKY, THE SOCIETY OF MIND, 236 (1985) ("[C]ulture [is] the conceptual treasures our communities accumulate through history.").

[459] *Id.*