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### CORPORATIONS—RESTRICTIONS ON ALIENATION OF STOCK—WHEN VALID

The validity of a charter provision<sup>1</sup> giving the directors of a corporation the unrestricted power to purchase, retire, or cancel common stock at will was challenged by a newly-retired employee whose stock had been called by the company. *Held*: the provision

<sup>18</sup> See note 14 *supra*.

<sup>19</sup> Neb. Rev. Stat. § 39-1215 (Supp. 1953).

<sup>20</sup> Kirby v. Omaha Bridge Commission, 127 Neb. 382, 255 N.W. 776 (1934).

<sup>21</sup> This conclusion is supported by the fact that Wisconsin itself approved turnpike authority financing in *State ex rel Thomson v. Giessel*, 265 Wis. 185, 60 N.W.2d 873 (1953), and affirmed that holding in the instant case by stating that turnpike bonds in Wisconsin would not constitute an indebtedness of the state.

<sup>1</sup> The provision read: "(7) By unanimous vote of a full board of directors of the number fixed by the stockholders at their last annual meeting. all or any shares of common stock of the corporation held by such holder or holders as may be designated in such vote may be called at any

was not invalid *per se* and would support a call of common shares if not exercised arbitrarily.<sup>2</sup>

Plaintiff's refusal to comply with the corporate decree was based upon his contention that the broad power of the call provision created an unreasonable "restraint on alienation." However, plaintiff had been an officer and director of the corporation for over 25 years, and had voted for the adoption of the challenged provision. He knew that the purpose of the provision was to keep all stock in the hands of active officers and directors and that it had been an invariable practice for retiring officers and directors to sell their stock either to other shareholders or to the corporation. While the decision is thus justified by the facts,<sup>3</sup> it may appear to sanction an arbitrary call power much broader than is required to achieve the end which motivated it, i.e., keeping all stock in the hands of active officers and directors.<sup>4</sup>

"Restraints on alienation" of stock are those restrictions which limit unimpeded transfer of the share from holder to holder.<sup>5</sup>

time for purchase, or for retirement, or cancellation in connection with any reduction of capital stock, at the book value of such shares as determined by the board of directors as of the close of the month next preceding such vote. Such determination, including the method thereof and the matters considered therein, shall be final and conclusive." *Lewis v. H.P. Hood & Sons, Inc.*, 121 N.E.2d 850 (Mass. 1954).

<sup>2</sup> *Lewis v. H.P. Hood & Sons, Inc.*, 121 N.E.2d 850 (Mass. 1954).

<sup>3</sup> Plaintiff had been an employee of defendant corporation since 1913, and had been a member of the board of executives since 1922. He was assistant treasurer for twelve years. He retired as a director in 1952. After his retirement, he was asked to sell his stock to the corporation, but did not do so. The directors thereupon called 1,540 of his shares. Plaintiff owned 3,648 of the 215,939 outstanding common shares. All stock was held by officers, directors, and their families, except for some shares held by two charitable trusts. Plaintiff's shares were the only shares called, and the call was made for the first time since the adoption of the provision in 1925. Plaintiff had voted for the adoption of the provision, and twice voted in favor of reaffirming it. He purchased the majority of his stock after the provision had been adopted. *Lewis v. H.P. Hood & Sons, Inc.*, 121 N.E.2d 850, 851 (Mass. 1954).

<sup>4</sup> The court read the provision in the instant case as though it limited use of the call power to stock of retiring officers and directors. Analogous provisions have been held valid. See *Harker v. Ralston Purina Co.*, 45 F.2d 929 (7th Cir. 1930); *Arentsen v. Sherman Towel Service Corp.*, 352 Ill. 327, 185 N.E. 822 (1933).

<sup>5</sup> *Fleitman v. John M. Stone Cotton Mills*, 186 Fed. 466 (5th Cir. 1911); *Winchell v. Plywood Corp.*, 324 Mass. 171, 85 N.E.2d 313 (1949); *Mitchell v. Lewensohn*, 251 Wis. 424, 29 N.W.2d 748 (1947); *McDonald v. Farley & Loetscher Mfg. Co.*, 226 Iowa 53, 283 N.W. 261 (1939); *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926); *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 Pac. 1153 (1913).

An unlimited power to call shares does not restrict their transfer in so many words but does limit the possibility of transfer in fact.<sup>6</sup> Courts distinguish between "restraints on alienation" and limitations merely "affecting the quality" of the shares.<sup>7</sup> The latter characterization has been used to denote limitations on transferability which were not invalid or harmful per se.<sup>8</sup> "Restraint" has generally been applied to more formidable obstacles to transfer.<sup>9</sup>

In Delaware, the state from which Nebraska borrowed its corporation statutes, a leading case<sup>10</sup> struck down a provision which forbade transfer without first offering the stock to the corporation and which rendered any stock not held by an employee callable at any time. The court could find no justification for its use.<sup>11</sup>

Massachusetts, forum of the instant case, permits greater "restraint"<sup>12</sup> than does Delaware.<sup>13</sup> However, if the restrictions

<sup>6</sup> The effect of the broad language would seem to preclude any "sensible" man from buying the stock. See *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A.2d 249 (1938).

<sup>7</sup> *Lewis v. H.P. Hood & Sons, Inc.*, 121 N.E.2d 850 (Mass 1954); *Prindiville v. Johnson & Higgins*, 92 N.J. Eq. 515, 113 Atl. 915 (1921).

<sup>8</sup> For example the provision that, if shares were transferred to one who was not an officer, director, or employee, dividends would not be paid to the transferee unless he surrendered his shares in exchange for a dividend certificate. Thus, he would be entitled to dividends. but no vote. *Prindiville v. Johnson & Higgins*, 92 N.J. Eq. 515, 113 Atl. 915 (1921).

<sup>9</sup> For example the restriction that, if the shareholder wishes to transfer his shares, he shall, for a limited period, offer them first to other shareholders or to the corporation. Of course, the corporation must have authority to purchase its own shares and must have a surplus out of which the purchase may be made. *Lawson v. Household Finance Corp.*, 17 Del. Ch. 1, 147 Atl. 312, aff'd, 17 Del. Ch. 343, 152 Atl. 723 (1930).

<sup>10</sup> *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A.2d 249 (1938).

<sup>11</sup> In the instant case, the court, without mentioning reasonableness or justification, assumed that the provision would be justifiable if it had actually read as the court construed it to read. *Lewis v. H.P. Hood & Sons, Inc.*, 121 N.E.2d 850, 853 (Mass. 1954).

<sup>12</sup> *Brown v. Little, Brown & Co.*, 269 Mass. 102, 168 N.E. 521 (1929); *Longyear v. Hardaman*, 219 Mass. 405, 106 N.E. 1012 (1914); *Barrett v. King*, 181 Mass. 476, 63 N.E. 934 (1902).

<sup>13</sup> *Tracey v. Franklin*, 31 Del. Ch. 510, 70 A.2d 250 (1949); *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A.2d 249 (1938); *Starring v. American Hair & Felt Co.*, 21 Del. Ch. 380, 191 Atl. 887 (1937). Nebraska follows Delaware in many instances, as the Nebraska corporation code was in large part borrowed from the Delaware code. See *Ritchey*

here were more narrowly worded, e.g., so as to be validly exercised only if stock were transferred to or held by a non-employee, and a legitimate reason for its use could be shown, Delaware, and thus perhaps Nebraska, would probably uphold the less ambitious restriction.<sup>14</sup>

Because of its liberal rule on "restraint", Massachusetts would probably uphold the instant provision even where the equities<sup>15</sup> were appreciably weaker. But such approval is open to criticism. The broad language of the provision creates an effective restraint on alienation which may be greater than the Nebraska law would allow.<sup>16</sup> It is doubtful that anyone would purchase stock subject to an unrestricted call power. The prerogatives of ownership should be determinable at the time of purchase, by resort to the terms of the restriction; while under the rule of the instant case, i.e., where provisions are not invalid per se, they would be indefinite until the provision had been litigated.<sup>17</sup>

and Vold, *General Corporation Law of Nebraska*, 21 Neb. L. Rev. 197 (1942). However, the legitimacy of a restraint is a common law problem; so Nebraska would be free to follow the Massachusetts view should it so desire.

<sup>14</sup> *Tracey v. Franklin*, 31 Del. Ch. 510, 70 A.2d 250 (1949); *Lawson v. Household Finance Corp.*, 17 Del. Ch. 1, 147 Atl. 312, *aff'd*, 17 Del. Ch. 343, 152 Atl. 723 (1930).

<sup>15</sup> It appears that the Massachusetts court in the instant case rested its decision largely upon the equities involved, those concerning the plaintiff specifically and closely-held corporations generally. The plaintiff had long been affiliated with the corporation, and knew of the existence and purpose of the provision. And the very purpose of a closely-held corporation is to maintain control in a small, integrated group. Restrictions which the group imposes on itself should be, and often are sustained, on a contractual basis if on no other. See *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W.2d 864 (1954); *Elson v. Schmidt*, 140 Neb. 646, 1 N.W.2d 314 (1941); *Searles v. Bar Harbor Banking & Trust Co.*, 128 Me. 34, 145 Atl. 391 (1929); *Weiland v. Hogan*, 177 Mich. 626, 143 N.W. 599 (1913); *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432 (1894).

<sup>16</sup> In *Miller v. Farmers' Milling & Elevator Co.*, 78 Neb. 441, 110 N.W. 995 (1907), the Nebraska court struck down a provision which completely restrained alienation. The broad language of the provision in the instant case in effect precludes any transfer.

<sup>17</sup> Such a provision can be analogized to the "void for vagueness" doctrine of constitutional law. To satisfy the Due Process Clause, a criminal statute must clearly spell out to men of reasonable intelligence the acts which it makes criminal, so that they may keep their conduct within the law. *Winters v. New York*, 333 U.S. 507 (1948); *United States v. L. Cohen Grocery Co.*, 255 U.S. 81 (1921).

It is submitted that a provision in corporate articles of incorporation which gives the corporation power to retire, purchase, or cancel common stock at will is too broad on its face, and substantially restrains alienation. Such a provision may be acceptable if used for legitimate ends by a closely-held corporation, and thus the principal case seems justifiable. However, it would seem wiser for the draftsman to phrase restrictions to adhere more closely to the ends sought to be attained. Otherwise, a sweeping provision, although enacted for legitimate purposes, might be stricken down as imposing an illegitimate restraint in a situation where a more carefully drafted clause would have been upheld.

James W. Hewitt, '56