Volume 63
Issue 3 *Dickinson Law Review - Volume 63, 1958-1959*

3-1-1959

Restrictions on Stock Transfer

Follow this and additional works at: https://ideas.dickinsonlaw.psu.edu/dlra

Recommended Citation
Restrictions on Stock Transfer, 63 DICK. L. REV. (1959).
Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol63/iss3/5

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.

NOTE

RESTRICTIONS ON STOCK TRANSFER

"Small" or "closely held" business enterprises are frequently incorporated for the purpose of limiting liability.[1] The recent amendment to the Internal Revenue Code of 1954, which permits shareholders of such corporations to elect to be taxed as partnerships, serves as an added and even greater inducement to incorporate since the undesirable "double taxation" feature is removed.[2]

It is of primary concern to shareholders of "closed" corporations that outside persons do not become stockholders, for conceivably a foreign intrusion could jeopardize the enterprise's existence, as the close corporation and confidence of the original incorporators might seriously be impaired.[3] Moreover it is often desirable to maintain permanently the original proportion of stock held by each stockholder,[4] and in light of Internal Revenue Code change the number of stockholders must be limited in order to preserve the newly conferred tax benefit. Therefore, it is usually advisable to effect some type of restriction on the alienation of stock.[5] The unwary incorporators, however, in attempting such restrictions can fall into a host of pitfalls erected by the courts, the legislators and the draftsman's lack of perception. This article is devoted to uncovering some of these pitfalls.

Originally, stock restrictions were considered contrary to public policy because they hampered free transfers of personal property, and they were held void.[6] But the courts have subsequently sanctioned "reasonable" restrictions in light of the surrounding circumstances.[7] The orthodox rationale for this judicial view has been expressed by Chief Justice Holmes in the following manner:

---

[1] 12 Fletcher, Corporations § 5453 (revised ed. 1957).

[2] Int. Rev. Code of 1954 § 1372, added by 72 Stat. 1606 (1958).

[3] For a case illustrating this problem see: Bechtold v. Coleman Realty Co., 367 Pa. 208, 79 A. 2d 661 (1951).

[4] See, Boswell v. Buhl, 213 Pa. 450, 63 Atl. 56 (1906); Aiken v. Dickinson, 305 Pa. 176, 157 Atl. 471 (1931).

[5] For discussions on this subject see: P.L.E., Corporations § 142 (1958); 12 Fletcher, Corporations §§ 5452-5461 (revised ed. 1957); Ballantine, Corporations § 337 (revised ed. 1946); O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 Harv. L. Rev. 773 (1952); and Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 Va. L. Rev. 229 (1951).

[6] Victor G. Bloede Co. v. Bloede, 84 Md. 129, 34 Atl. 1127 (1896); Brightwell v. Mallory, 10 Yerg. (Tenn.) 196 (1836); Barnard v. Desautels, Rap. Jud. Quebec, 19 K.B. 114 (1909).

[7] Garvin's Estate, 335 Pa. 542, 6 A. 2d 796 (1939); Barrett v. King, 181 Mass. 476, 63 N.E. 934 (1902); Lawson v. Household Finance Corp., 17 Del. Ch. 743, 152 Atl. 723 (1930); and Guaranty Laundry Co. v. Pulliam, 198 Okl. 667, 181 P. 2d 1007 (1947).

"Stock in a corporation is not merely property. It also creates a personal relation analogous otherwise than technically to a partnership. . . . There seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm." [8]

The basic restrictive plans are:

(1) "consent restraints" requiring the stockholders' or the board of directors' unanimous approval before a stock transfer can be made, or the consent of a stipulated percentage of either group;[9]

(2) "first option" provisions, sometimes referred to as "first refusals", whereby a holder or his personal representative before transferring in any manner must first offer to sell his stock to the other stockholders or the corporation;[10] and,

(3) "buy and sell agreements" between a stockholder and the remaining shareholders or the corporation.[11] The parties enter into an agreement binding the stockholder to sell and obligating the other contracting party to buy the former's stock upon the happening of a stipulated event.

In addition, numerous variations or combinations of these plans are often utilized to fulfill the needs of individual situations. But before selecting an appropriate plan, the practitioner must ascertain which restrictions conform to the court's test of "reasonableness".

Despite the fact that consent restraints have the advantage of excluding undesirable outsiders without tying up the funds of either the corporation or the shareholders staying in the enterprise, one Pennsylvania lower court has held them void because "the effect of this agreement is to put the stockholder's power to sell his stock in the hands of and make it dependent upon the will of others." The court went on to say:

"In the . . . Reading Terminal Railroad case, an agreement in which it was stipulated that no sale of stock should be made by any stockholder without the action of a majority of the signers thereof was declared void. If an

---

[8] Barrett v. King, 181 Mass. 476, 477, 63 N.E. 934, 935 (1902).

[9] See, White v. Ryan, 15 Pa. County Ct. 170 (1894); Miller v. Farmer's Mill & Elevator Co., 78 Neb. 441, 110 N.W. 995 (1907); and Douglas v. Amrora Daily News Co., 160 Ill. App. 506 (1911).

[10] See, Garrett v. Philadelphia Lawn Mower Co., 39 Pa. Super. 78 (1909); Feldstein's Estate, 25 Pa. Dist. 602 (1916); and Bloomingdale v. Bloomingdale, 107 Misc. 646, 177 N.Y. Supp. 873 (1919).

[11] See, Wann v. Blum, 309 Pa. 551, 161 Atl. 596 (1933); and Halkias v. Liberty Laundry Co., 361 Pa. 475, 64 A. 2d 800 (1949).

> agreement requiring only a majority of stockholders to assent to the sale is void, clearly one requiring unanimous consent must be void." [12]

On the other hand, first option [13] and buy and sell agreements [14] have been received favorably by the Pennsylvania courts. In *Fitzsimmons v. Lindsay*,[15] the court ruled that:

> "Each subscribing stockholder acquired a preferred right by way of option, to purchase the shares of the other if they died or withdrew from the business first. This is a mutual and sufficient consideration to make a binding contract. . . . Nor is the objection that the agreement is in restraint of alienation sufficient. Such agreements are quite common among partners as to their shares in the firm's assets and are enforced by courts without hesitation. No reason of overruling public policy is apparent why they should not also be sustained in relation to shares of stock in what is really only a private trading company." [16]

Since neither first option provisions nor buy and sell agreements are invalid, selection of one or of a combination of the two will depend upon the incorporator's reasons for imposing such restraints as well as the circumstances of each individual case. First option provisions, seemingly the most widely used, can be framed to include all possible situations of stock transfers; whereas, buy and sell agreements are usually, by choice, limited to stock acquisitions when a holder dies, possibly because the parties feel they should not be compelled to buy stock due to a holder's voluntary act. Another reason for so limiting buy and sell arrangements is that some individual business situations seem to dispel the likelihood that sales or transfers will be contemplated by a stockholder during his lifetime; consequently, it is only necessary to provide for purchasing his stock when death occurs. Still other situations will warrant a coupling of both the first option and the buy and sell arrangement into one restriction, the former covering sales and transfers during a shareholder's life and the latter covering stock disposition at death. This combination has an advantage over a strict first option in that it is more likely to assure the deceased's estate a fair price for the stock. Where the existing stockholders are the only prospective purchasers in a closely held corporation the advantage is obvious beyond comment.

Assuming that a first option provision will be selected in one form or another, it should be drafted with precision, for the interpretation of restrictive

---

12 White v. Ryan, 15 Pa. County Ct. 170, 177-178 (1894). *Contra,* Farmer's Mercantile & Supply Co. v. Laun, 146 Wis. 252, 131 N.W. 366 (1911); Longyear v. Hardman, 219 Mass. 405, 106 N.E. 1012 (1914); and Wright v. Iredell Telephone Co., 182 N.C. 308, 108 S.E. 744 (1921).

13 Fitzsimmons v. Lindsay, 205 Pa. 79, 54 Atl. 488 (1903); Garrett v. Philadelphia Lawn Mower Co., 39 Pa. Super. 78 (1909); and Feldstein's Estate, 25 Pa. Dist. 602 (1916).

14 Wand v. Blum, 309 Pa. 551, 164 Atl. 596 (1933); and Halkias v. Liberty Laundry Co., 361 Pa. 475, 64 A. 2d 800 (1949).

15 205 Pa. 79, 54 Atl. 488 (1903).

16 *Id.* at 80, 54 Atl. at 489.

provisions, rather than their validity has given rise to most litigation. Draftsman of such agreements should be mindful that restrictions, though not generally invalidated by consideration of public policy, are regarded with disfavor and will be strictly construed,[17] and the courts tend to recognize only the incorporator's desire to keep outside parties from purchasing the stock. No other reasons for the restriction are recognized unless they are explicitly stated.[18] It should also be noted that at least one jurisdiction has held seemingly clear restrictions so vague as to be undeserving of specific performance.[19]

In view of this, the first option provision should, among other things, recite what occurrence will create the option. Parties may desire options to arise in any or all of the following events: voluntary sales or transfers, dispositions by will, sales by one shareholder to another, pledges, seizure and sales by legal process and other transfers by operation of the law. In any event those situations intended to be included should be clearly and specifically set forth in the restriction.

Voluntary sales are usually covered by even the most poorly penned restrictions. Likewise, there is no problem where a testator bequeaths his shares to a third person, since his personal representatives will be bound to perform the agreement under ordinary contract principles.[20] Nevertheless, it is advisable to specifically bind the holder's personal representative by appropriate words in the restriction in order to discourage unnecessary litigation.

The courts are not willing to enforce a restriction against a sale by one stockholder to another unless the agreement expressly includes such a transaction.[21] The reason for this is that it is assumed that the general restrictive purpose is to thwart outside intrusions, and a sale by one shareholder to another does not violate that purpose. In an agreement designed to preserve the proportional holding, the contemplated offer to stockholders in proportion to their present holdings should be clearly defined. Moreover, unless a provision restricts "transfers" and not "sales" alone, a stockholder will be permitted to pledge his stock,

---

[17] Trilling & Montague, 140 F. Supp. 260 (E.D. Pa. 1956); and McDonald v. Farly & Loetscher Mfg. Co., 226 Iowa 53, 283 N.W. 261 (1939).

[18] Boswell v. Buhl, 213 Pa. 450, 63 Atl. 56 (1906); Garvin's Estate, 335 Pa. 542, 6 A. 2d 796 (1939); and Serota v. Serota, 168 Misc. 27, 5 N.Y.S. 2d 68 (1938).

[19] Hardin v. Rosenthal, 213 Ga. 319, 98 S.E. 2d 901 (1957). The restrictive agreement in this case provided that in the event a holder desired to sell any of his shares he should first offer them to the existing stockholders at market value or true value. The option was to remain open for a six-month period. It was further provided that the option could only be waived by a writing, and that the restriction was to be printed on all stock certificates.

[20] Garvin's Estate, 335 Pa. 542, 6 A. 2d 796 (1939).

[21] Serota v. Serota, 168 Misc. 27, 5 N.Y.S. 2d 68 (1938); and Guaranty Laundry Co. v. Pulliam, 198 Okl. 667, 181 P. 2d 1007 (1947).

although the pledgee is usually required to give the other parties an opportunity to purchase before foreclosure.[22]

It should be noted with particularity that restrictive stock agreements apply only to voluntary transfers and not to judicial sales or other transfers by operation of law unless, from the terms of the agreement, a converse conclusion is clearly inescapable.[23] An explanation given for this view is that a restrictive stock agreement is analogous to restrictions on the assignability of property leases which have always been strictly construed.[24] In *Trilling and Montague* [25] the court set forth another explanation by reiterating the rule of construction that restrictions are intended solely to protect the corporation from unwelcome members. This being the case, the problem is merely one of price, since there is no possibility of a secret sale without notice. All the stockholder must do is be present and be the highest bidder at the sale. Although the rule that stock restrictions do not apply to judicial sales seems to be firmly established, the draftsman might do well to expressly cover judicial sales and other transfers by operation of law in a restrictive stock agreement. A court confronted with such explicit language might find that the restriction inescapably embraces such situations and give effect to the true intention of the parties. In those jurisdictions where such a restriction is contrary to statutes requiring like property to be sold at public auction to the highest bidder express coverage of judicial sale will be of no avail—such a restriction can never be valid.[26]

It is equally advisable to clearly identify the optionees and state their relative rights. If the shareholders are named optionees, the agreement should state whether:

(1) each is entitled to purchase in accordance with the ratio between his holdings and those of all shareholders having options on the shares offered;

(2) each party is entitled to acquire equal parts of the offered shares despite his existing holdings; or

(3) any shareholder is privileged to exercise the option on a "first come, first served basis."

The draftsman should not overlook drafting a provision for the disposition of stock that an optionee declines to buy. Should any other holder be free to

---

22 Monotype Composition Co., Inc. v. Kierman, 319 Mass. 546, 66 N.E. 2d 565 (1946); and Estate Funds, Inc. v. Burton-Fifth Ave. Corp., 111 N.Y.S. 2d 596 (1952).

23 Barrows v. National Rubber Co., 12 R.I. 173 (1878); McDonald v. Farly & Loetscher Mfg. Co., 226 Iowa 53, 283 N.W. 261 (1939); and Trilling & Montague, 140 F. Supp. 260 (E.D. Pa. 1956).

24 McDonald v. Farly & Loetscher Mfg. Co., 226 Iowa 53, 283 N.W. 261 (1939).

25 140 F. Supp. 260 (E.D. Pa. 1956).

26 Barrows v. National Rubber Co., 12 R.I. 173 (1878).

purchase or should it be offered *pro rata* to the accepting offerees? If the corporation is named optionee it is important to state whether the stocks purchased are to be retired, held as treasury shares, issued as stock dividends, or sold to an acceptable purchaser.

In addition to listing occurrences which give rise to the option, a good option agreement will provide the procedure for accomplishing the desired objective. For example, it will recite when the option is to begin, and state whether the offeror or his representative must give written or oral notice to the offeree, or whether the offer arises automatically on the happening of the specified event. An illustration of what can happen when this is overlooked is provided by *Dearden v. Dearden.*[27] In this case a stockholder filed a bill in equity to compel another holder to specifically perform a contract in which it was agreed that upon his son's death the defendant "must offer" his shares to the petitioner within 60 days. The Court found that the option arose automatically. There was no need for such an offer since "the agreement was self-executing and the condition precedent having been fulfilled, Edward Dearden did, for a period of 60 days after the death of his son, offer to sell the stock in question. This option to purchase the stock, not having been accepted by the person to whom it was given, expired at the end of the sixty days [following the death of the decedent]." [28]

Equally important is the inclusion of a clause stating the period within which the optionee may exercise the option, and the length of time the parties have to effectuate the transfer and pay the purchase price. With relation to the option's time limit, sufficient time should be given to the corporation as optionee in order that a meeting of the directors can be called to decide whether the option will be accepted. Ample time must, likewise, be given to the shareholder-optionees, so that it will be possible for them to arrange the financing.

A method or formula fixing the price of shares offered ought to be agreed upon and stated in the restrictive agreement.[29] This will preclude future disputes, since it is easier to establish an acceptable formula while the buyers and seller are unknown. The price may be one based on "net worth",[30] "par value",[31] "book value" [32] or that which a bona-fide purchaser would pay if the

---

[27] 360 Pa. 225, 61 A. 2d 348 (1948).

[28] *Id.* at 226, 61 A. 2d at 349.

[29] For a discussion of this topic see: Forester, *Valuing a Business Interest for the Purpose of a Purchase and Sales Agreement,* 4 Stan. L. Rev. 325 (1952); and O'Neal, *supra* note 5.

[30] Mowry v. McWherter, 365 Pa. 232, 74 A. 2d 154 (1950).

[31] Garrett v. Philadelphia Lawn Mower Co., 39 Pa. Super. 78 (1909).

[32] Garvin's Estate, 335 Pa. 542, 6 A. 2d 796 (1939); and Chrisman v. Avil's Inc., 80 Pa. D.&C. 395 (1952).

offer were extended to him.[33] The latter device, however, seems to beg the question—since such a clause is synonymous with a "reasonable price", and like the failure to state any price or formula, is likely to result in litigation. Perhaps the most popular method is to establish a fixed price amendable periodically (usually every six months and never longer than one year) in accordance with business changes, and providing for arbitration if an agreement cannot be reached.[34] If book value is used it is advisable to fix its calculation at the end of the last preceding fiscal or calendar year or some other designated fiscal period rather than upon the happening of the specified event. This will avoid the costly procedure of a special audit.

There is in addition to the above mentioned difficulties of drafting restrictive clauses one problem inherent to both first options and buy and sell agreements. This problem is the uncertainty of available funds when a purchase is to be consummated. This uncertainty is the prime factor for adopting a first option rather than a buy and sell agreement. This problem of available funds also comes into play when determining the parties to an agreement. Pennsylvania law permits corporations to purchase their stock only out of unrestricted and unreserved earned surplus or unrestricted capital surplus [35] which may not be available when the time comes; therefore, preference in many cases is given to stockholders by operation of a mandatory corporate default. Obviously, strict buy and sell agreements should be used only when the prospective buyer is relatively certain that the purchase price will be on hand when needed.

One solution to the problem is the combination of business insurance with the restrictive stock agreement.[36] The close corporation insurance agreement is a written contract, either among the stockholders individually, and known as the stock purchase plan, or between the corporation and its stockholders, and known as the stock redemption plan. Under the stock purchase agreement, each stockholder carries insurance on the life of every other stockholder in an amount sufficient to underwrite his obligation to purchase the insured's stocks. The buyer agrees to purchase that portion of stock the deceased owns which represents the ratio of shares held by such survivor to those owned by all the survivors. Thus if A, B and C are sole stockholders in the corporation, and they own 100, 200 and 300 shares respectively, upon the death of C, A would agree to purchase 100 shares and B would agree to purchase 200 shares. Assuming that each share is worth $100, A would insure C's life for $10,000 and B would insure C's life

---

33 Aiken v. Dickinson, 305 Pa. 176, 157 Atl. 471 (1931); and Trilling & Montague, 140 F. Supp. 260 (E.D. Pa. 1956).

34 Fitzsimmons v. Lindsay, 205 Pa. 79, 54 Atl. 488 (1903).

35 Pa. Stat. Ann. tit. 15, § 2852-701 (1957).

36 For discussions on this subject see: Phillips, *Life Insurance Trusts: A Recapitulation for the Draftsman,* 81 U. Pa. L. Rev. 408 (1933); and Comment, 39 Mich. L. Rev. 1194 (1941).

for $20,000. It is obvious that stock purchase agreements can become an extremely complicated network of cross options and insurance contracts if there is a sizable number of stockholders. To illustrate, an agreement among seven stockholders would require forty-two insurance policies. For this reason, stock redemption plans are generally preferable to stock purchase arrangements in such a situation. Under this agreement, the corporation insures the life of each stockholder to the extent the valuation of his shares or a portion thereof. Thus an agreement involving seven shareholders would call for 7 policies rather than 42.

Many times business insurance may be coupled with the use of a trustee to assure the performance of the buy and sell agreement.[37] By this device the trustee is named beneficiary of the insurance policies while the stockholders assign their shares to him endorsed in blank without surrendering their rights as shareholders. Upon death, the trustee transfers the deceased's stock to the surviving shareholders or to the corporation, and the purchase price is paid to the executor of the decedent's estate in accordance with the agreement.

There are several detriments in using business insurance. For example, every time a stock transfer is consummated a new agreement must be drafted, or a shareholder might be uninsurable. In the latter situation there is no completely satisfactory solution, although an annual premium retirement annuity contract is frequently used. This arrangement builds up a reserve which is improved with interest over a period of years. One other disadvantage of both stock purchase and stock redemption insurance plans is that premiums may be prohibitively expensive.

If business insurance or a strict buy and sell agreement is used, a clause should provide for termination of the agreement upon the corporation's bankruptcy or dissolution. A provision should be inserted allowing a shareholder after disposing of all his shares or the termination of the agreement to purchase any insurance policy on his life by paying an amount equal to its cash surrender value computed as of the date such right is exercised. The agreement also should terminate upon the death of two or more holders occurring either simultaneously or successively in a close time sequence. Otherwise, although one representative can compel the remaining parties to purchase his shares, he in turn will be required to buy some of the other estate's holdings—an undesirable dilemma.

Although the drafting of a restriction which will best bring about the desired goal is often tedious and difficult the problem does not end here; for

[37] See, Greater New York Carpet House, Inc. v. Herschman, 258 App. Div. 649, 17 N.Y.S. 2d 483 (1940), holding such an agreement valid because the corporation bargained to pay the insurance premiums.

the draftsman will next have to decide whether the agreement will be placed in the articles of incorporation, the by-laws, a restrictive stock agreement or a combination of two or more.[38] "Generally, commentators suggest that the restriction be included both in shareholders' agreements and in the articles of incorporation." [39] This conclusion has been reached because some jurisdictions refuse to validate restrictions appearing in the by-laws on the basis that stock restrictions are not within the purview of by-laws.[40] True, many state statutes provide that the corporation shall "make by-laws not inconsistent with existing law, for the management of its property, the regulation of its affairs, *and the transfer of its stock,*" but courts often hold that such authorization refers only to the procedural aspect of making stock transfers on the corporation books.[41] Moreover, it has been affirmatively asserted, in supporting the charter as an effective instrument wherein the restrictions can be set out, that when the Secretary of State approves the articles of incorporation, he thereby gives the state's consent to the restrictions set forth therein; hence, parties other than the state will not ordinarily at a later date successfully assail the restriction as being unreasonable and contrary to the public policy of the state.[42] At least, the courts might be rather hesitant to reverse the secretary's decision. The advocates of charter restrictions have also reminded their readers that courts have held that the charter represents not only a contract between the corporation and the state, but also a contractual relationship between the stockholders and the corporation.[43] One court has held such a provision requires the unanimous consent of all the stockholders in order to be amended.[44] Whether or not the rule is sound, in most jurisdictions it would seem wise to include the restriction in the articles of incorporation. Although some of the jurisdictions have held void by-laws to constitute a valid contract,[45] it seems unwise to rely on this mere possibility.

In Pennsylvania a contrary view is taken, and the courts will not strike down reasonable restrictions appearing in the by-laws.[46] In *Garrett v. Philadelphia*

---

[38] For a general discussion of this subject see: 12 Fletcher, *op. cit. supra* note 5; O'Neal, *supra* note 5; and Cataldo, *supra* note 5. For a collection of cases on this subject see: Annot., 65 A.L.R. 1159 (1930); 138 A.L.R. 773 (1942); and 61 A.L.R. 2d 1318 (1958).

[39] 12 Fletcher, *op. cit. supra* note 5, at 224.

[40] Driscold v. West Bradley & C. Mfg. Co., 59 N.Y. 96 (1874); Brinkerhoff-Farris Trust & Savings Co. v. Home Lumber Co., 118 Mo. 447, 24 S.W. 129 (1893); Ireland v. Globe Mill Co., 21 R.I. 9, 41 Atl. 258 (1898); and Kritzer v. Cole Bros. Lightning Rod Co., 193 Mo. App. 99, 181 S.W. 1066 (1916).

[41] Morris v. Hussong Dyeing Mach. Co., 81 N.J. Eq. 256, 80 Atl. 1026 (1913); and Kritzer v. Cole Bros. Lightning Rod Co., 193 Mo. App. 99, 181 S.W. 1066 (1916).

[42] Cataldo, *supra* note 5.

[43] 12 Fletcher, Corporations § 5453 (revised ed. 1957); see also, Lawson v. Household Finance Corp., 17 Del. 343; 152 Atl. 723 (1930).

[44] Johnson v. Tribute-Herald Co., 155 Ga. 204, 116 S.E. 810 (1923).

[45] Weiland v. Hogan, 177 Mich. 626, 143 N.W. 599 (1913); and Model Clothing House v. Dickinson, 146 Minn. 367, 178 N.W. 957 (1920).

[46] Garrett v. Philadelphia Lawn Mower Co., 39 Pa. Super. 78 (1909); and Elliott v. Lindquist, 356 Pa. 385, 52 A. 2d 180 (1947).

Lawn Mower Co.[47] the court held a restriction binding not merely as a by-law, but also as an agreement between the parties, where they all assented to the adoption of the regulations and agreed thereto before incorporation. As a necessary corollary to this conclusion, the six year statute of limitation will apply to claims of an alleged breach of the contract.[48] Accordingly, such a by-law regulation is governed by contract rules, and contractual parties cannot ignore their covenant with impunity and still seek to hold the others to it.[49] Equally logical is the conclusion that by-laws adopted inconsistently with a prior stock agreement constitutes a modification of the original contract.[50] And finally, the Supreme Court in 1951, presented with a stockholder's attempt to amend a stock restriction in the by-laws by a majority vote, was of the opinion that:

> "Provisions in corporate by-laws may, generally speaking, be divided into two classes (a) those that are mere regulations governing the conduct of the internal affairs of the corporation. These may be repealed, altered or amended at the will of the majority unless a greater vote is required by the by-laws themselves or by statute. (b) Provisions in the nature of a contract which are evidently designed to vest property rights *inter se* among all stockholders. These cannot be repealed or changed without the consent of the other parties whose rights are affected." [51]

In light of this interpretation, the objections against inserting stock restrictions into by-laws raised in other jurisdictions are completely removed in Pennsylvania. In addition, there are practical reasons for preferring by-law to charter restrictions. Although there is no case authority on the subject, the Pennsylvania Business Corporation Law authorizes "any provision not inconsistent with law which the incorporators may choose to insert for the regulation of the internal affairs of the corporation and the business of the corporation" to be inserted in the *articles of incorporation.*[52] Literally construed this would appear to authorize the inclusion of restrictive stock provisions in the *articles of incorporation.* But statutes of other jurisdictions having similar language pertaining to *by-law content* have been so construed that restrictive stock provisions are said to be outside the purview of such statutes and therefore the inclusion of such restrictions are not authorized.[53] It is suggested that the Pennsylvania courts might reach the same result in regard to *articles of incorporation* by applying the reasoning of those courts.

[47] 39 Pa. Super. 78 (1909).

[48] Elliott v. Lindquist, 356 Pa. 385, 52 A. 2d 180 (1947).

[49] *Ibid.*

[50] Halkias v. Liberty Laundry Co., 361 Pa. 475, 64 A. 2d 800 (1949).

[51] Bechtold v. Coleman Realty Co., 367 Pa. 208, 213, 79 A. 2d 661, 663 (1951).

[52] Pa. Stat. Ann. tit. 15, § 2852-204 (1957).

[53] See note 41 *supra.*

Perhaps even more convincing is the argument that the Secretary of State might question stock restrictions which do not fall within the orthodox type familiar to him. Assuming that a drafted restriction provides for protection in all possible situations, it is likely to be unorthodox. Why then invite a possible dispute when restrictions can be so easily effected by inserting them in the by-laws? Therefore, if the stockholders agree on a first option or buy and sell agreement its inclusion in the by-laws should be sufficient. However, where the agreement is complicated, as for example when coupled with business insurance to fund a buy and sell agreement, a separate stock agreement should also be entered into spelling out in detail the exact intentions of the parties.

It seems then that there are three steps to creating an effective restrictive stock agreement. First, the objects or results desired must be determined; secondly, the method through which these objectives are to be obtained must be set forth; and finally, the instrument or instruments which incorporate the agreement must be carefully chosen. The foregoing merely points out some of the common but not obvious problems which are often overlooked. It is believed that proper consideration of and deliberation on these problems will enable the practitioner to draft effective agreements. There are, however, two further statutory requirements that should be considered. First, the restriction must be placed on each stock certificate in order to effectively bind a purchaser not a party to the agreement;[54] and second, pre-emptive rights on the issuance of *additional* shares must be provided for in the articles of incorporation.[55] This latter requirement is extremely important since proportionate shareholdings could as readily be disturbed by issuing additional shares as by transferring existing shares unless appropriate restraints are imposed, and because it has been held that by-law restrictions apply only to issued stock.[56]

ARTHUR E. SAYLOR.

[54] Pa. Stat. Ann. tit. 12A, § 8-204 (1953). Even actual knowledge on the part of the purchaser is insufficient if the words of restriction or the existence of the restriction with a reference to the place in which it may be found do not appear conspicuously on the security.

[55] Pa. Stat. Ann. tit. 15, § 2852-611 (1933).

[56] Chrisman v. Avil's Inc., 80 D.&C. 395 (1952).