the Third Circuit in finding for its constitutionality chose to emphasize the statute's role as an implementation of previous remedies against litigious harassment.[22]

RESTRAINTS ON ALIENATION OF STOCK CERTIFICATES

In *Tracey v. Franklin*,[1] two stockholders had placed a majority of shares of class B stock of a Delaware corporation in a voting trust, naming themselves co-trustees. Class B was entitled to elect two of seven directors. The agreement provided that during the trust period of ten years the parties, as depositing stockholders, would not "sell their respective stock so deposited . . . [nor] their respective voting trust certificates . . . nor any interest in the shares of stock represented thereby. . . ."[2] As trustees, they agreed not to sell the stock deposited in trust except upon the consent given and terms stipulated by both depositing stockholders. Upon the death of either party, the survivor was to have an option to purchase the interest of the decedent. No other stockholder was to be admitted into the trust.

In a suit for specific performance by one of the parties, the Delaware Court of Chancery held that the restrictions upon the alienation of the stock interests as represented by the trust certificates were "unreasonable" and nonseparable, and that the entire trust agreement was therefore void.

Although it has been said that in the general field of restraints on alienation, "courts must . . . examine economic and social policy to a greater extent than in many other fields,"[3] the doctrine against restraints on stock transfer has never been explicitly analyzed in the light of the objectives underlying the policy against restraints. Thus, without such analysis, restraints have been invalidated merely on the ground that "the right to transfer is a right of property" and that an unreasonable restraint "amounts to an annihilation of property."[4]

on the general objectives which it seeks to attain. It would seem particularly harsh to impose these stringent new requirements on plaintiffs who have already changed their position in reliance on the previous derivative suit mechanism.

[22] The Supreme Court, in an opinion published too late for comment in the foregoing note, has affirmed the third circuit court of appeals. Beneficial Industrial Loan Corporation v. Smith, 17 U.S.L. Week 4530 (1949). The majority held that the order denying security could be directly appealed (contra: Aspinook v. Bright, op. cit. note 6); that the statute did not violate substantive due process; and that it represented an important state policy and should consequently apply in federal courts with diversity jurisdiction under the Erie rule as developed in the Angel and York cases. Rutledge, J., in his dissent decried the increasingly broad application of the Erie rule, stating that it was not intended to interfere with federal court procedure.

[1] 61 A. 2d 780 (Del. Ch., 1948).

[2] Ibid., at 781.

[3] Manning, The Development of Restraints on Alienation since Gray, 48 Harv. L. Rev. 373 (1935).

[4] Penthouse Properties v. 1158 Fifth Avenue, 256 App. Div. 685, 11 N.Y.S. 2d 417, 422 (1939), citing Fisher v. Bush, 35 Hun. (N.Y.) 641 (1885); cf. People ex rel. Malcom v. Lake Sand Corp., 251 Ill. App. 499 (1929); Searles v. Bar Harbor Banking & Trust Co., 128 Me.

One common objection to restraints on alienation is that property should be free to answer for the debts of the owner.[5] The possibility of protecting property from creditors by means of the restrictions imposed by a spendthrift trust was Gray's chief argument against that device.[6] Restrictions so imposed are valid against both voluntary and involuntary transfers.[7] On the other hand, restrictions on transfer of stock certificates are enforceable only against voluntary transfers and not against judicial sales for the benefit of creditors.[8]

A second argument against restraints is that an economic system built upon freedom of commerce requires readily marketable property.[9] Any limitation on marketability restricts the number of possible alternate uses to which the restricted property can be put and may thereby prevent the most effective allocation of resources. However, the adverse effects of noneconomic diversion of resources ensue only where the restricted property constitutes a significant proportion of the class of property suitable for the use barred by the restriction. The usual economic effect of restraints is simply an upward adjustment in the price of similar property not so restricted. However, the policy of the law appears to be to frustrate attempted restraints at their beginnings, regardless of immediate economic effects, the theory probably being that by such vigilance the broader, more objectionable restraints on competition can be more easily prevented.

The "property" contemplated by this argument would not seem to include corporate stock. It is true that control of the majority of stock of a corporation assumes effective control over the underlying property, but it does not follow that a restraint on stock transfer constitutes a restraint on the disposition of the underlying property. Whatever the particular incidents of the stock ownership may be, the corporate property itself will be utilized to the economic advantage of the corporation as the majority stockholders view it, and, if an otherwise

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34, 145 Atl. 391 (1929); State ex. rel. Howland v. Olympia Veneer Co., 138 Wash. 144, 244 Pac. 261 (1926); Scruggs v. Cotterill, 67 App. Div. 583, 73 N.Y. Supp. 882 (1902); Bloede Co. v. Bloede, 84 Md. 129, 34 Atl. 1127 (1896); Bank of Atchison County v. Durfee, 118 Mo. 431, 24 S.W. 133 (1893); In re Klaus, 67 Wis. 401, 29 N.W. 582 (1886).

Shares of Stock are personal property by statute (e.g., Del. Rev. Code [1935] § 2048) and at common law. Cook, Corporations § 331 (8th ed., 1923). Compare McNulta v. Corn Belt Bank, 164 Ill. 427, 447, 45 N.E. 954, 959 (1896).

But in Gray, Restraints on Alienation § 29d (2d ed., 1895), it is said: "The interest of a partner in a partnership, or of a shareholder in an unincorporated or corporated company, may... be made non-assignable. In the absence of agreement the right of a partner is generally presumed to be non-assignable, and of a shareholder to be assignable; but this may in both cases be changed by the terms of the articles or by-laws. The law does not force fellowship on any one without his consent."

[5] Manning, op. cit. supra note 3, at 403.

[6] Gray, Restraints on the Alienation of Property, Preface viii–ix (2d ed., 1895).

[7] Griswold, Spendthrift Trusts §§ 265, 267 (1936).

[8] McDonald v. Farley & Loetscher Mfg. Co., 226 Iowa 53, 283 N.W. 261 (1939); cf. First Nat. Bank of Canton v. Shanks, 34 Ohio Ops. 359, 73 N.E. 2d 93 (1945).

[9] Manning, op. cit. supra note 3, at 403.

competitive market is assumed, this allocation of resources will be most advantageous to society as a whole. In short, a restraint on stock transfer is no direct restriction on the marketability of the corporate property; nor is it a limitation on the alternate productive uses to which corporate property may be put.

Only one argument for the rule against restraints on stock transfer considers policy as it relates to the corporation, namely, that the power freely to transfer one's stock and the power to acquire a larger block may be the only effective safeguards available to the small investor who fears management policies will lead to corporate loss.[10] Arguably, these safeguards are dubious in the case of the small or closely held corporation whose shares are not readily marketable even without restraints. On the other hand, it may be urged that when the property is not readily marketable initially, additional obstacles should not be imposed by agreement.

While the courts have not supported their assumption that the general rule against restraints is applicable to corporate stock they have had to turn to policy in their attempts to define the scope of reasonable and allowable restraints. It has been observed that this shift in attention has been marked by increasing liberality in the courts when passing upon the validity of restrictive agreements involving corporate interests, the power granted to employ voting trusts being cited as an example.[11]

The reasonableness of restraints on stock alienation is said to turn upon whether the given restraint is "necessary and convenient to the attainment of the objects for which the company was incorporated."[12] Such restrictions may be imposed by charter, by-laws, or agreement.[13] The corporate "necessity and convenience" served may be administrative: thus, a provision requiring the registration of shares with the management so that it may know who are the shareholders of record is valid as a reasonable restraint.[14] But corporate necessity and convenience of a different order may support another class of restraints. Restrictions are valid which create a preferential option to purchase in favor of corporation, directors, or shareholders; the giving of notice of intention to transfer; the resale of stock to the corporation by employee-stockholders upon the termination of employment; a prohibition against transfers to any but members of a limited class; the reservation in corporation or stockholders of the right to purchase shares of a decedent stockholder; and restrictions on transfer of shares not fully paid for.[15] This class of restraints is designed to afford stockholders

[10] Ballantine, Corporations 777 (rev. ed., 1946).

[11] Lawson v. Household Finance Corp., 17 Del. Ch. 343, 353, 152 Atl. 723 (1930).

[12] Ibid., at 352, 727.

[13] While the source of the restriction has apparently had influence in determining its validity in some cases, such distinction should probably not be controlling. Ballantine, Corporations 779 (rev. ed., 1946).

[14] 8 Fletcher, Cyc. Corp. § 4206 (perm. ed., 1931).

[15] Ballantine, Corporations § 337 (rev. ed., 1946).

"protection . . . against possible injurious changes in the control and management of the corporation, and [some] power to select one's associates, an advantage possessed by partnerships but usually not available to corporations."[16] In upholding these restraints, the courts place less emphasis upon the attributes of stock as personal property and more upon its nature as an interest in an enterprise, comparing it to a partnership interest. As Chief Justice Holmes of the Massachusetts Supreme Court declared in a frequently cited passage, "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."[17] Where the partnership analogy is accepted it would support a requirement that all shareholders consent to transfers of stock, since consent is necessary for the transfer of a partnership interest if the partnership is not to be dissolved. However, the courts do not follow the partnership analogy this far.[18]

This analogy of stock interests to partnership interests is more likely to be employed in upholding a restraint when the number of stockholders is small,[19] or when the stock concerned is that of a closed corporation,[20] or when the restraint in question effects an identity of ownership with control in the corporate structure.[21]

In view of these considerations, the *Tracey* case may be criticized not only for its failure to examine the economic and social policy served by the rule against restraints on stock alienation, but also for its failure to examine the reasonableness of the particular restraints involved in the light of the objectives they sought to attain.

The restrictions involved in the instant case were imposed through a voting trust agreement. Since the voting trustees were also the holders of the equitable interest, the voting trust did not operate to separate control and equitable own-

[16] Restrictions on Transferability of Shares of Stock, 42 Harv. L. Rev. 555, 556 (1929). In Lawson v. Household Finance Corp., 17 Del. Ch. 1, 13, 147 Atl. 312, 317 (1929), a case extensively drawn upon in the instant case, the Delaware court said "such a purpose is manifestly commendable." However, in Greene v. E.H. Rollins & Sons, 22 Del. Ch. 394, 2 A.2d 249 (1938), relied upon in the present case, the Lawson case was narrowly limited to its facts and it was pointed out that a small loan company, involved in the Lawson case, had an unusually strong reason for desiring to maintain the integrity of its stockholding class.

[17] Barrett v. King, 181 Mass. 476, 479, 63 N.E. 934 (1902). In the early history of American corporations, this "right to choose one's associates" was exercised to prevent stock subscription by speculators and other undesirables, but not without risk of being charged with monopolizing. 2 Davis, Essays in the Earlier History of American Corporations 321 (1917).

[18] In re Klaus, 67 Wis. 401, 29 N.W. 582 (1886); cf. Miller v. Farmers Milling & Elevator Co., 78 Neb. 441, 110 N.W. 995 (1907) (consent by directors required).

[19] 87 U. of Pa. L. Rev. 482, 483 (1939), noting Greene v. Rollins & Sons, 22 Del. Ch. 394, 2 A. 2d 249 (1938.)

[20] Ibid.

[21] Ibid.

ership (the most objectionable characteristic of voting trusts),[22] but to consolidate the powers of the holders of a majority of shares of class B stock. In view of settled policy in Delaware as to the validity of voting trusts, the restrictions on transfer of interest could be viewed as a guaranty to each of the parties that the other, who, as voting trustee, was to share responsibility in the voting of class B, would, at all times, maintain a financial interest in the success of the enterprise. It has been said that restrictions on stock transfer designed to assure the corporation of management by persons "animated by a deep personal interest"[23] are "manifestly commendable."[24] Similar objectives were being pursued in the present case. By guaranteeing the unitary voting of class B stock, the restraints may have promoted the further commendable objectives of securing for that minority class of stock more effective representation on the board of directors.

Had the parties here not tried to restrict the alienability of the trust certificates, or, as is conceivable, had the restraints been found to be not so essential as to render the entire trust void by their invalidity,[25] it would have been possible for one or both of the parties to sell their equitable interests, retaining representation in the corporation as voting trustees. While such arrangements are generally valid, the great weight of criticism that has been thrown against the separation of control and equitable ownership through the voting trust device[26] suggests that an attempt by the agreement of the parties to prevent such separation should be considered reasonable. Of course, the foregoing analysis assumes that the primary objective of the parties was to establish the voting trust and that the restraint on alienation was an incidental feature operating to fuse voting power and ownership. The obvious difficulty with this analysis is that there is no indication as to which of these objectives was the primary agreement. The court's holding that the alienation provisions were an inseparable part of the total agreement suggests that in its view the restraints on alienation were of coordinate, if not of primary, importance. If this were not the view of the court, the voting trust agreement need not have been invalidated.

Whether strong policy arguments support the rule in the *Tracey* case may be

[22] The "separation of ownership and control" is one of the most important effects of a voting trust, according to Leavitt, The Voting Trust 7 (1941), and the resulting minority control is "the weightiest single factor" against the use of voting trusts. Ibid., at 166. The debate over the validity and value of the voting trust has been long and drawn out.

In 1937, Commissioner (now Justice) William O. Douglas characterized the voting trust as "a vehicle for corporate kidnapping." N.Y. Times, p. 37 (March 25, 1937). But Dewing declares, "Everything in this world of ours is subject to the dangers of abuse, from man's procreative powers to gooseberry tarts at Thanksgiving." 1 Dewing, Financial Policy of Corporations, 129 note y (4th ed., 1941). For a summary of the debate that has raged over voting trusts and citations to writings in the field, see Leavitt, The Voting Trust c. viii (1941).

[23] Lawson v. Household Finance Corp., 17 Del. Ch. 1, 12, 147 Atl. 312, 317 (1929).

[24] Note 11 supra.

[25] Tracey v. Franklin, 61 A. 2d 780, 785 (1948).

[26] Note 22 supra.

tested in another way. Voting trusts are not generally considered to be "genuine" trusts.[27] However, the rule—that restraints on alienation of the beneficial interest of stock are unreasonable when similar restraints against the stock itself would be unreasonable—could be applied equally well to the interests in a genuine trust. Provisions in a genuine trust agreement would be analogous to those in the voting trust agreement in the present case if the beneficiary were restrained from transferring his beneficial interest in the trust property, e.g., shares of stock. Statutes in some states permit such restraints against the beneficiary of a trust established to collect rents and profits.[28] A few states specifically forbid the transfer of the beneficial interest by the beneficiary of a trust created to receive income and profits to be applied to the use of another.[29] In legalizing spendthrift trusts, courts and legislatures have decided that individuals considered by the settlor to be inexperienced or wasteful are to be protected from the rule against restraints on alienation even though the property placed in trust may support strong policy arguments for that rule.[30] Absent more clearly articulated objections to restraints on stock transfer, the upsetting of a voluntary agreement, that operates to assure the identity of voting rights and ownership, is questionable.

When the legality of a given restraint on stock transfer is before the courts, a satisfactory result would seem more likely to be assured by a close examination of the particular restraint sought to be imposed and the special corporate purposes such restraint was designed to serve. If such should become the rule of the courts, not only might the boundaries of "reasonable" restraints become more sharply outlined, but the whole policy against restraints on alienation of property in general, as well as corporate stock, might be exposed to view: "A standard based on the purposes of the restraints should make it more imperative for the judges consciously to weigh the benefits involved and rationally to expound their results."[31]

[27] But see Gose, The Legal Characteristics and Consequences of Voting Trusts, 20 Wash. L. Rev. 129 (1945).

[28] Bogert, Trusts § 72 (2d ed., 1942).

[29] Ibid.

[30] Ibid., at § 45.

[31] Manning, op. cit. supra note 3, at 406.