IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

THE CAPITAL GROUP COMPANIES, INC., a Delaware corporation,	)	
Plaintiff,	)	
v.	)	C.A. No. 422-N
TIMOTHY D. ARMOUR and NINA L. RITTER, individually and as Trustees of the Ritter-Armour Trust, dated August 6, 1991, as amended,	)	
Defendants.	)	

MEMORANDUM OPINION AND ORDER

Submitted: February 24, 2005
Decided: March 15, 2005

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LAMB, Vice Chancellor.

A Delaware corporation brought this suit against the two trustees of a trust, who are husband and wife, seeking a declaration that certain contractual stock transfer restrictions alleged to apply to shares of its Class A common stock[1] owned by the trust are valid and enforceable. The two defendants are parties to a divorce proceeding pending in the Superior Court of California and, in connection with that proceeding, the wife has claimed an interest in the stock now owned by the trust. The issue is whether the stock transfer restrictions may reasonably operate to prevent the transfer to, or disposition in favor of, the wife of any legal or beneficial interest in the stock.

I.

The Capital Group Companies, Inc. ("CGC") is a privately-held Delaware corporation with its principal place of business in Los Angeles, California. The defendants are Timothy Armour and Nina Ritter, husband and wife, who are the trustees of the Ritter-Armour Revocable Trust dated August 6, 1991, as amended (the "Trust"). Armour is an Executive Vice President of Capital Research and Management Company, a subsidiary of CGC, and a director of CGC.

CGC requires all persons purchasing shares of its common stock to become parties to a Stock Restriction Agreement ("SRA") that contains several provisions relevant to this case, including a general restriction on transfer,[2] and a right to

[1] All references to "stock" refer to CGC's Class A common stock, unless otherwise noted.
[2] SRA § 2.1.

redeem[3] that allows the stock to be repurchased at a formula price upon its transfer to a non-authorized transferee.[4] In general, the SRA precludes the transfer of stock to any non-employee of CGC (such as Ritter) and allows CGC the right to repurchase shares if they are transferred to a non-employee.

In 1984, Armour and Ritter were married and, in 1989, began buying CGC common stock. All stock purchased between 1989 through mid-1998 was purchased in Armour's name. In October 1998, for tax planning purposes, and with CGC's consent, the defendants placed the stock owned by Armour into the Trust. In order to comply with the SRA, and to gain CGC's consent to the transfer, the defendants amended the Trust (the "Trust Amendment"), several provisions of which are relevant to the resolution of this case. The Trust Amendment provides that the Trust may not distribute any stock held in the trust without the consent of CGC.[5] The Trust Amendment also makes reference to the SRA and provides that,

[3] SRA § 4.8.1.
[4] SRA § 4.2.
[5] Trust Amendment Art. IV, § E states, in pertinent part:

> Notwithstanding any trust provision that requires or permits a distribution of trust assets to me made by the Trustee to any trust beneficiary, the Trustee shall not distribute any [stock] to any trust beneficiary without the prior written consent of CGC, which consent may be granted or withheld in CGC's sole and absolute discretion. If CGC gives prior written consent to a transfer, each such Permitted Transferee shall execute and deliver to CGC a Joinder Agreement as a condition of any transfer. Any Transfer of [stock] other than to a Permitted Transferee who has executed and delivered to CGC the required Joinder Agreement shall be a "Non-Authorized Transferee" [sic] (as that term is defined in the [SRA]).

upon revocation of the Trust, if the stock is not immediately transferred to Armour, CGC has the right to repurchase it.[6]

In connection with transferring the stock to the Trust, in their capacities as trustees, Armour and Ritter signed a so-called Joinder Agreement,[7] agreeing to be bound by the SRA. Thereafter, through 2002, again with the consent of CGC, the parties continued to purchase stock in the name of the Trust. In connection with those purchases, defendants signed so-called Purchaser Representation Letters,[8] again agreeing to be bound by the SRA. The Trust, as amended, provides that

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[6] Trust Amendment Art. IV, § F states, in pertinent part:

> Upon revocation or termination of the trust, or in the event the trust is amended in a manner inconsistent with the [SRA] as determined by CGC, the Trustee shall promptly either transfer all [stock] to [Armour], if he is living and if such transfer is authorized by the terms of the trust. If such transfer is not so authorized or if [Armour] is not then living, the Trustee shall offer to sell, pursuant to the requirements and procedures set forth in the [SRA], all [stock] held by the Trustee. If [stock is] to be transferred by the Trustee to [Armour], he shall execute and deliver to CGC a Joinder Agreement as a condition of any transfer. The Trustee shall not distribute or otherwise transfer [stock] to any "Person" (as that term is defined in the [SRA]) (including a trust beneficiary) without the prior written consent of CGC, which consent may be granted or withheld in CGC's sole and absolute discretion.

[7] The Joinder Agreement states, in pertinent part:

> We hereby agree and state that by signing this Joinder Agreement, the trust and each of us individually, in our capacity as trustees of the trust, are parties to, accept all of the obligations of, and are bound by all of the terms of the [SRA] and all of the provisions with respect to A Shares set forth in the trust.
>
> We understand that all stock certificates that we are acquiring as trustees have a restrictive legend and may not be sold, assigned, pledged or otherwise transferred except in accordance with the provisions of the [SRA] and state and federal securities laws.

[8] The Purchaser Representation Letter states, in pertinent part:

> The Purchaser has read and understood all of the terms of the [SRA] and agrees to accept all of the obligations of, and to be bound by all of the terms of such Agreement with respect to all Stock of the Company presently being purchased or now owned by the Purchaser[.]

either Ritter or Armour may act on behalf of the Trust, but that only Armour can vote the stock held by the Trust.[9]

In June 2003, Armour filed for divorce in California. The stock held in the Trust represents the bulk of the value of the community property from the marriage. Despite the transfer restrictions in the SRA, Ritter plans to ask for an award of a direct or indirect interest in the stock held in the Trust.[10] Specifically, Ritter has stated that, pursuant to the divorce proceeding and the distribution of community property therewith, she will ask the California court to award the stock to Armour, and order Armour to make continuing payments to her in order to accomplish an equitable distribution of the community estate.[11] The amount that she will request that Armour be ordered to pay will be one-half of all dividends that Armour receives from the stock and one-half of any net sale proceeds that he receives from the sale of the stock, if and when he sells the stock (the "Requested Distribution").[12]

Anticipating that Armour or CGC, or both, would contend that the Requested Distribution is prohibited by the SRA, Ritter sought to join CGC as a

[9] Trust Amendment Art. IV, § H.
[10] "Ritter believes that continued ownership of the stock is so valuable and beneficial that to receive anything less than an in-kind division would result in an unequal division of the community estate." Br. in Support of Mot. and Decl. for Joinder, dated May 27, 2004, filed by Nina L. Ritter in *Armour v. Ritter*, Case No. 390510 (Super. Ct., Los Angeles County, CA June 24, 2004) at 10.
[11] Ritter Decl. ¶ 4.
[12] *Id.*

party to the divorce proceeding. When that gambit failed, CGC filed this action against Ritter and Armour, in their capacity as trustees, seeking the following judgment:

> b. declaring that the SRA is valid and enforceable;
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> d. declaring that the award of a record, beneficial or other interest to Ritter in connection with the California Divorce Action would constitute an unauthorized transfer, such that CGC would be entitled to repurchase or redeem any CGC stock transferred to Ms. Ritter (directly, beneficially or otherwise) in accordance with the SRA and CGC's Certificate of Incorporation.[13]

On June 14, 2004, Ritter moved to dismiss the original complaint based on lack of personal jurisdiction, insufficiency of process, insufficiency of service of process, and failure to state a claim upon which relief can be granted. On July 30, 2004, CGC filed a motion for leave to file an amended complaint, and on August 4, 2004, the court granted CGC's motion. In the amended complaint,[14] CGC sought the same declaratory relief against the defendants in their capacity as trustees, and added claims against Ritter individually. On August 6, 2004, Ritter renewed her motion to dismiss for lack of personal jurisdiction. By Memorandum Opinion and Order, this court denied Ritter's motion to dismiss.[15]

On November 16, 2004, CGC filed a motion for summary judgment on all claims. While not formally filing a cross-motion for summary judgment, Ritter

[13] Compl. p. 9.
[14] Hereinafter the amended complaint is referred to as simply the complaint.
[15] *Capital Group Co. v. Armour*, 2004 Del. Ch. LEXIS 159, at *2 (Del. Ch. Oct. 29, 2004).

requested in her answering brief that the court exercise its inherent power to grant summary judgment in her favor.[16] Therefore, the court treats CGC's motion and Ritter's response as cross-motions for summary judgment.

II.

On a motion for summary judgment pursuant to Rule 56, judgment will be granted where the moving party demonstrates that there are no genuine issues of material fact in dispute and the moving party is entitled to judgment as a matter of law.[17] The burden is on the moving party to prove an absence of a material issue of fact and the court must review all evidence in the light most favorable to the non-moving party.[18] However, if the moving party puts into the record facts which, if undenied, entitle it to summary judgment, the burden shifts to the defending party to dispute the facts by affidavit or proof of similar weight;[19] i.e. the party opposing summary judgment is obliged to adduce some evidence showing the existence of a dispute of material fact.[20] Rule 56(e) states in relevant part:

> When a motion for summary judgment is made and supported as provided in this Rule, an adverse party may not rest upon the mere

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[16] *See, e.g.*, *Stroud v. Grace*, 606 A.2d 75, 81 (Del. 1992) ("[I]n the interests of judicial economy, Chancery Court Rule 56 gives that court the inherent authority to grant summary judgment *sua sponte* against a party seeking summary judgment."); *Cont'l Ins. Co. v. Rutledge & Co.*, 2000 Del. Ch. LEXIS 40, at *2 (Del. Ch. Feb. 14, 2000) ("Delaware law clearly entitles this Court to grant summary judgment upon suggestion of the non-moving party or *sua sponte* against a party seeking summary judgment.").
[17] *Scureman v. Judge*, 626 A.2d 5, 10 (Del. Ch. 1992).
[18] *Id.* at 10-11.
[19] *Tanzer v. Int'l Gen. Indus., Inc.*, 402 A.2d 382, 385 (Del. Ch. 1979).
[20] *Id.*

> allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this Rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him.

III.

In the complaint, CGC seeks a declaration from this court that: (1) any disposition of an interest in the stock contained in the Trust, made without CGC's consent, violates the SRA; and (2) the SRA is valid and binding on Ritter. Ritter argues that the requested declaration is too vague and uncertain to be granted. She also argues that she is not bound by the SRA because, she claims, the SRA, by its terms, does not apply to the distribution of marital assets that she has requested from the California court. Finally, Ritter argues that, even if the SRA does preclude the requested distribution of marital assets, this restriction on the transfer of shares is unreasonable and, therefore, void as against public policy.

CGC counters with three arguments. First, CGC argues that the terms of the SRA specifically preclude the disposition of marital assets that Ritter has requested from the California court. Second, CGC contends that Delaware law does not require that restrictions on transfers of stock be reasonable. Finally, CGC claims that, even if Delaware law does require that restrictions on transfers of stock be reasonable, the restrictions contained in the SRA meet this test. The court will address each of these arguments in turn.

A. Is The Requested Declaratory Judgment Too Vague And Uncertain To Be Granted?

The complaint seeks a declaration that "the award of a record, beneficial or other interest" to Ritter "would constitute an unauthorized transfer" under the SRA. Because the SRA defines "transfer" narrowly as: "[a] transfer of record of Shares,"[21] Ritter contends that it would be inherently contradictory or ambiguous for the court to rule that the SRA prohibits the "transfer" of a "beneficial or other" interest where no prohibited change in record ownership is entailed.

While it is true that the definition of "transfer" found in the SRA is quite narrow, the court does not read the request for relief found in the complaint in the same restrictive manner. Complaints are to be construed liberally.[22] Therefore, the court reads the term "transfer," as contained in the complaint, broadly, to mean dispose, alienate, assign, or convey.[23] So understood, the request for a declaration that the disposition, alienation, assignment or conveyance of any ownership interest in CGC shares is prohibited by the SRA is neither ambiguous nor inconsistent with the SRA.

[21] SRA § 9.39.
[22] *See* Del. Ch. Ct. R. 8(e)(1).
[23] This broad reading of the word "transfer" is only for the purposes of deciding whether the declaration CGC requested is inherently contradictory or overly vague.

B. Does The SRA Specifically Preclude The Disposition Of Marital Assets That Ritter Has Requested From The California Court?

Ritter states that, pursuant to the divorce proceeding and the distribution of community property therewith, she will ask the California court to award the stock to Armour, and order Armour to continue making payments to her in order to accomplish an equitable distribution of the community estate.[24] Ritter's Requested Distribution will be one-half of all dividends that Armour receives from the stock and one-half of any net sale proceeds that he receives from the sale of the stock, if and when he sells the stock.[25] CGC argues that this would constitute a violation of the SRA.

Section 2.1 of the SRA states, in pertinent part:

> No Stockholder shall sell, assign, transfer (whether by merger, operation of law or otherwise), dispose of or encumber any of the Stockholder's Shares or any interest therein except as specifically provided in this Agreement. Any purported or attempted sale, assignment, transfer, disposition or encumbrance of Shares or any interest therein not in strict compliance with this Agreement shall be void and shall have no force or effect.

It is indisputable that a transfer of direct, record ownership of the stock from the Trust to Ritter would violate the SRA. However, Ritter argues that the Requested Distribution does not violate this section of the SRA because: (1) the Requested Distribution will not give Ritter an "ownership interest," (2) the

[24] Ritter Decl. ¶ 4.
[25] *Id.*

Requested Distribution is not a "transfer," as that term is defined in the SRA, and (3) even if the Requested Distribution is a transfer and does give Ritter an ownership interest in the stock, the SRA does not preclude Ritter from having such an ownership interest.

First, Ritter claims that the Requested Distribution would not violate the SRA because it would not give her an ownership interest. She would not be an owner of record, and she would not have a right to vote the shares. Instead, she would have an interest in half of the dividends and half of any proceeds from the sale of the stock.

It is difficult to see how the right to receive dividends and the right to receive proceeds upon the sale of the stock does not constitute an "interest" in the stock. The rights to receive dividends and proceeds from a stock are two of the sticks in the bundle of rights that have traditionally been the hallmarks of stock ownership.[26] In the Requested Distribution, Ritter seeks to have the California court award her these rights in the stock. Ritter tries to avoid the conclusion that this is an ownership interest by stating that she would *only* have an interest in Armour's assets directly commensurate with, and dependent upon, the proceeds he receives from the stock. This is a distinction without a difference. Under the Requested Distribution, payments to Ritter, like those to Armour (who undeniably

[26] *See In re Digex S'holders Litig.*, 2002 Del. Ch. LEXIS 40, at *10 (Del. Ch. Apr. 16, 2002).

would have an ownership interest in the stock) would be completely dependent on the distribution of dividends or the sale of stock. The Requested Distribution would give Ritter an equitable entitlement to half the proceeds from dividends paid on the stock, and half the proceeds from any sale. This is clearly an "interest," and an ownership interest, that is prohibited by the SRA.

Second, Ritter's contention that the Requested Distribution would not be a "transfer" that violates the SRA is true, but not dispositive. Section 9.39 of the SRA defines a "Transfer" as "[a] transfer of record of Shares as reflected in the stock book of CGC maintained by CGC or its stock transfer agent, as the case may be." Ritter correctly points out that, since the Requested Distribution would not make her a record holder, it would not constitute a prohibited "transfer of record." This is so because the only transfer of record ownership would be to Armour, which is permitted under the SRA. Section 2.1 of the SRA, however, precludes more than "transfers" of an interest in the stock. It also precludes dispositions and assignments, two terms not defined in the SRA. Therefore, the court must interpret these terms using their common and ordinary meaning.[27] "Assign" generally means "to transfer to another in writing . . .; *specif.* to transfer (property) to another

[27] *See, e.g., Northwestern Nat'l Ins. Co. v. Esmark, Inc.*, 672 A.2d 41, 44 (Del. 1996) (interpreting unambiguous contract terms using dictionary definitions); *Neary v. Philadelphia, W. & B. R. Co.*, 9 A. 405, 407 (Del. 1887) ("All written contracts, as well as legislative Acts, are to be read, understood and interpreted according to the plain meaning and ordinary import of the language employed in them.").

in trust or for the benefit of creditors."[28] "Dispose" generally means "to transfer into new hands or to the control of someone else (as by selling or bargaining away)."[29] Awarding Ritter the right to share in both the dividends paid on the stock and proceeds from its sale would qualify as both a disposition and an assignment. Therefore, it would violate the SRA.[30]

C. Does Delaware Law Require That Stock Restrictions Be Reasonable?

Ritter also argues that the transfer restrictions found in the SRA are unreasonable and, thus, unenforceable. CGC counters that, under Delaware law, a stock restriction need not be reasonable.

The transfer restrictions contained in the SRA are governed by 8 *Del. C.* § 202, which sets forth the requirements for a valid restriction on the transfer of securities. The first two of those requirements, that the restriction must be conspicuously noted on the stock certificate and that the restriction may be imposed either in the corporation's certificate of incorporation or in its bylaws, are not at issue.[31] What is at issue is whether the other, substantive features of the stock transfer restrictions satisfy the remaining statutory criteria of section 202 for a legally permissible restriction on the transfer of a corporation's stock.

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[28] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 132 (3rd ed. 1976).
[29] *Id.* at 654.
[30] Ritter also contends that, even if the Requested Distribution was a transfer and did give Ritter an ownership interest in the stock, the SRA does not preclude Ritter from having such an ownership interest. The court addresses this argument in its discussion of the reasonableness of the restrictions, *infra*, Section III(D)(2).
[31] *See* 8 *Del. C.* §§ 202(a) and 202(b).

Before section 202's 1967 enactment, Delaware courts held that restrictions imposed by a corporation on the transfer of its stock would be upheld only if those restrictions were reasonable.[32] Generally, a restriction was valid if it was reasonably necessary to advance the corporation's welfare or attain the objectives set forth in the corporation's charter.[33] A determination of the validity of those restrictions required balancing the policies served by the restrictions against the traditional judicial policy favoring the free transfer of securities.

In *Lawson*, the Delaware Supreme Court held that a corporation's right of first refusal contained in its stock was reasonable, and therefore valid.[34] The Supreme Court held that because the restriction was "necessary and convenient to the attainment of the objects for which the company was incorporated," retaining the stock ownership of the company among its employees was reasonable.[35]

In *Greene*, this court indicated that a corporate charter provision authorizing the corporation to buy a shareholder's stock at any time at its net asset value, even from an unwilling seller, might be an invalid restriction on transfer.[36] This court found that the only reason stated for the restriction was to perpetuate a company

[32] *See Lawson v. Household Fin. Corp.*, 152 A. 723, 727 (Del. 1930); *Greene v. E.H. Rollins & Sons*, 2 A.2d 249, 251-53 (Del. Ch. 1938).
[33] *See Lawson*, 152 A. at 727; *Greene*, 2 A.2d at 252.
[34] 147 A. at 317. The restriction at issue in *Lawson* is now expressly allowed by section 202(c)(1).
[35] *Id.*
[36] 2 A.2d at 251-53

consisting of shareholders who were "agreeable" to the board.[37] This court concluded that the power to redeem stock is "highly questionable if its avowed purpose was to get rid of certain stockholders of a given class solely because their presence in the stockholding group was undesirable to the rest."[38]

After the adoption of section 202, there was some uncertainty as to whether the common law requirement of a reasonable purpose for stock transfer restrictions continued. When faced with that issue in *Grynberg v. Burke*,[39] this court held that the statute is "no more than a modern codification of the [common law] principle"[40] and continued to apply the common law requirement that transfer restrictions serve a reasonable purpose.

In *Gyrnberg*, the defendants argued that the four categories of restriction contained in section 202(c) were *per se* valid. The court rejected this argument, stating that subsection (c):

> is no more than a modern codification of the principle adopted in *Lawson v. Household Finance Corp.*, namely, that a restraint on the free transferability of corporate stock . . . is permissible under our law provided it bears some reasonably necessary relation to the best interests of the corporation. § 202(e) merely backs up the provisions of § 202(c) by stating that any form of restriction other than those enumerated in subsection (c) is also permissible provided it meets the same test. If anything, it may be that § 202(c) places the burden of

[37] *Id.* at 252.
[38] *Id.* (citation omitted).
[39] 378 A.2d 139 (Del. Ch. 1977), *rev'd on other grounds, Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1, 8 (Del. 1981).
[40] *Id.* at 143.

> demonstrating the unreasonableness of such enumerated restrictions on the party attacking them.[41]

The decision in *Grynberg* has been cited approvingly and applied in several cases in this court.[42]

CGC asks this court to overturn *Grynberg,* solely on the basis of two non-Delaware cases decided more than 25 years ago. The first, *St. Louis Union Trust,*[43] decided a few months before *Grynberg*, held that section 202 had dispensed with the common law reasonableness test. In that case, the United States Court of Appeals for the Eighth Circuit based its decision on what that court viewed as the purpose of enacting the statute, i.e. to broaden the circumstances in which restrictions would be enforced in order to clear up the preexisting uncertainties in the common law.[44] In support of this proposition, the Eighth Circuit cited FOLK, THE DELAWARE GENERAL CORPORATION LAW, 198 (1972). The Eighth Circuit also relied on a Pennsylvania case construing a similar Pennsylvania statute. In the

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[41] *Id.*

[42] *See Mitchell Assocs. v. Mitchell*, 1980 Del. Ch. LEXIS 562, at*10 (Del. Ch. Dec. 5, 1980) (applying reasonableness standard and enforcing right of a company to buy stock at the death of the stockholder contained in a stockholder agreement); *Capano v. Wilmington Country Club*, 2001 Del. Ch. LEXIS 127, at *28 (Del. Ch. Oct. 31. 2001) (holding that country club's by-laws–which allowed it to expel a member for cause, required new members to buy shares of its stock, and restricted the transfer of the shares–were reasonably related to the club's "social, intellectual, and recreative" purposes); *Agranoff v. Miller*, 1999 Del. Ch. LEXIS 78, at *65 (Del. Ch. Apr. 9, 1999) (holding that refusal rights contained in a shareholder agreement were reasonable to the "proper corporate interest" in permitting the company's existing equity holders to maintain their proportionate interest in the enterprise in the event that other holders wished to sell or that the company wished to issue additional shares).

[43] *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977).

[44] *Id.* at 1046.

second case, *Kerrigan,*[45] the United States District Court for the Southern District of New York relied almost exclusively on *St. Louis Union Trust*.[46] Even though *Kerrigan* was decided a few months *after Grynberg*, *Grynberg* was not cited by the *Kerrigan* court.[47] Therefore this court must assume that the *Kerrigan* court mistakenly concluded that no Delaware cases construing section 202 existed. Although generally well-reasoned,[48] *St. Louis Union Trust* and *Kerrigan* can no longer be thought to reflect Delaware law. Rather, *Grynberg* has been the clearest statement of Delaware law on this subject for over 25 years, and has been cited approvingly numerous times by this court. The principle of *stare decisis* requires this court to follow *Grynberg*.

Moreover, section 202 has been amended twice since *Grynberg* was decided and on neither occasion did the General Assembly act to eliminate the reasonableness requirement found in that case. "It is, of course, a cardinal principle of statutory construction that the legislature is 'presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that

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[45] *Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 450 F. Supp. 639 (S.D.N.Y. 1978).
[46] *Id*. 645.
[47] *Id.*
[48] The reliance that these cases place on a passage of the original Folk treatise is misplaced. The passage cited referred to the forms of restrictions that would be acceptable under section 202. It did *not* refer to the issue of whether a reasonable business purpose was still required. This point was made in a subsequent treatise bearing Professor Folk's name. RODMAN WARD, JR., EDWARD P. WELCH & ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS, § 202.3 at GCL-VI-17 (4th ed. 2002).

interpretation when it re-enacts a statute without change.'"[49] As a result, the holding of *Grynberg* has been adopted as a matter of law.

For the above reasons, the court reaffirms the holding in *Grynberg* that a reasonableness inquiry is required when restrictions on the transfer of stock are contested.

D. Are The Stock Restrictions Contained In The SRA Reasonable?

Ritter argues that, as applied to her, the restrictions in the SRA are unreasonable.

The burden of proving that a stock restriction is unreasonable lies with the party contesting the validity of the restriction.[50] CGC has put forward numerous corporate policies that are advanced by the restrictions.[51] However, these polices can be summarized as having two main purposes. First, CGC argues that the ownership restrictions limit the number of shareholders in the company, so that CGC need not comply with the filing and disclosure requirements that federal securities law imposes on public companies. Second, CGC argues that restricting ownership interest in the company to employees and their immediate family members aligns the interests of the employees with those of the company, thereby enabling greater returns.

[49] *Allen v. Prime Computer, Inc.*, 540 A.2d 417, 420 (Del. 1988) (internal citations omitted).
[50] *Grynberg*, 378 A.2d at 143; *Agranoff*, 1999 Del. Ch. LEXIS 78, at *51-*52.
[51] *See* Pl. Reply Br. at 19-20.

CGC also relies on certain express provisions of section 202 in arguing that the restrictions are reasonable. The pertinent provisions are as follows:

> (c) A restriction on the transfer . . . of securities of a corporation . . . is permitted by this section if it:
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> * * *
>
> (3) Requires the corporation . . . to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities . . .; or
>
> (4) Obligates the holder of the restricted securities to sell or transfer an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing . . . ; or
>
> (5) Prohibits or restricts the transfer of the restricted securities to, or the ownership of restricted securities by, designated persons or classes of persons or groups of persons, and such designation is not manifestly unreasonable.[52]

Moreover, section 202(d) provides that any transfer for the purpose of "[m]aintaining any statutory or regulatory advantage or complying with any statutory or regulatory requirements under applicable local, state, federal or foreign law" "shall be conclusively presumed to be for a reasonable purpose . . . ."

In response, Ritter argues that, while perhaps reasonable in the abstract, the restrictions on ownership are not reasonable as they apply to her. First, the Requested Distribution will not increase the number of record shareholders, as that term is defined by SEC regulations.[53] Therefore, the Requested Distribution will

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[52] 8 *Del. C.* 202(c).

[53] The relevant statute, 17 CFR § 240.12g5-1 (2005) states, in pertinent part:

> Definition of securities "held of record"
>
> (a) For the purpose of determining whether an issuer is subject to the provisions of sections 12(g) and 15(d) of the Act, securities shall be deemed to be "held of record" by each person who is identified as the owner of such securities on

not affect CGC's filing and disclosure requirements with the SEC. Furthermore, CGC already allowed Armour to purchase more stock, which he holds in his own name. By distributing the stock held in the Trust to him, Ritter argues, the number of record shareholders would actually be reduced by one.

Second, Ritter argues that the SRA does not restrict a transfer of the stock (or an interest in the stock) to her. It only restricts such a transfer to her without CGC's consent which, she claims, has been unreasonably withheld. She notes that not all of CGC's stock is owned by CGC employees. At times, CGC has allowed charities and charitable remainder trusts to own stock.[54] In addition, the SRA allows certain "grandfathered" stock, i.e. stock owned since before 1967, to be owned by the heirs and spouse of the former owner.[55] It allows any disabled employee shareholder, who is no longer able to work for CGC, to transfer her stock to a fiduciary to act on her behalf.[56] It also allows any employee who retires to

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> records of security holders maintained by or on behalf of the issuer, subject to the following:
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> * * *
>
> (3) Securities identified as held of record by one or more persons as trustees, executors, guardians, custodians or in other fiduciary capacities with respect to a single trust, estate or account shall be included as held of record by one person.
> (4) Securities held by two or more persons as coowners shall be included as held by one person.

[54] Def. Ex. B, De Toledo Dep. at 60:25-52:3; 64:3-65:3.
[55] *Id.* at 166:8-172:6.
[56] *Id.* at 65:4-16.

continue to own the stock for up to six years.[57] For the past 20 years, approximately 20% of CGC's stock has been owned by these non-employees.[58]

1. What Is The Proper Scope Of The Reasonableness Inquiry?

Ritter's argument requires this court to decide the scope of the reasonableness inquiry. The parties argue for two different standards by which the court should apply the reasonableness inquiry. First, is the actual restriction reasonable to achieve a legitimate corporate purpose (as CGC argues)? Second, is the stock transfer restriction reasonable as it applies to a particular individual (as Ritter claims)?

The Delaware courts have been reluctant to invalidate stock restrictions because they are unreasonable. In the seminal case, *Greene,* discussed *supra*, this court questioned the validity of a transfer restriction that allowed a corporation to buy back its stock at any time, even from an unwilling seller.[59] Yet, the court did not invalidate the stock transfer restriction at issue. It decided only that a full hearing was needed to determine whether "the ends and purposes of the restraint complained against so related to the corporation's successful operation [] as to warrant the conclusion that the restraint is reasonable."[60] Moreover, the court

[57] SRA § 2.6.3.
[58] Def. Ex. B, de Toledo Dep. at 53:22-54:3.
[59] 2 A.2d at 254.
[60] *Id.*

examined whether the restrictions were reasonable or not on their face, not in how the restrictions were applied to the particular plaintiffs.[61]

In *Tracy v. Franklin*,[62] the Delaware Supreme Court upheld this court's invalidation of a voting trust agreement that prohibited the signatories from transferring their stock during the life of the trust. The court found no "legally sufficient purposes to justify the restraints."[63] The Supreme Court further noted that even if it is a stockholder agreement that restricts the transfer of shares, "some purpose must appear, other than an unexplained desire to make [the shares] inalienable."[64] Again, the Supreme Court questioned the validity of the stock restriction on its face, and *not* how it was applied.

Since the adoption of section 202, the Delaware courts have been broadly deferential to the decisions of market participants when they decide to place restrictions on stocks. The court in *Mitchell* upheld the validity of a stockholder agreement that required the sale of the company's stock back to the company, at a formula price, upon the shareholder's death.[65] The court found the restriction reasonable in relation to the company's purpose, i.e. "maintain[ing] some measure

[61] *Id.* at 253 ("In substance [the stock restriction] borders close upon a restraint against transferring the property to any one in the whole world except to the corporation, for such must be the effect as a practical matter of the obligation of the holder at any time to sell to the corporation upon its demand.").
[62] 67 A.2d 56, 59-60 (Del. 1949).
[63] *Id.* at 60.
[64] *Id.*
[65] 1980 Del. Ch. LEXIS 562, at *10.

of choice in taking in new shareholders."[66] Both *Grynberg*[67] and *Agranoff*[68] place the burden of proving that a stock restriction is invalid on the party attacking the restriction. Moreover, the intention behind section 202 was to be broadly deferential to market participants.[69] "Given the deference that should be granted toward a stock restriction that is expressly authorized by the Code, a reviewing court should not excessively scrutinize the reasonableness of the restriction."[70]

In light of the reluctance of our courts to invalidate stock restrictions, and the broad deference that should be given to the decisions of market participants to enter into such restrictions, the court holds that a deferential reasonableness inquiry is required when courts are asked to invalidate a stock transfer restriction. This approach is also consistent with the general principle that Delaware corporate law is enabling, and does not impose choices on market participants. Therefore, the proper inquiry is whether the actual restrictions are reasonable to achieve a legitimate corporate purpose.

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[66] *Id.* at *9.
[67] 378 A.2d at 143.
[68] 1999 Del. Ch. LEXIS 78, at *51-*52.
[69] *See* FOLK, THE DELAWARE GENERAL CORPORATION LAW (1972), 198-199 (stating that section 202 "go[es] well beyond the scarce and often restrictive case law both in Delaware and elsewhere."); *Agranoff*, 1999 Del. Ch. LEXIS 78, at *51 ("Delaware public policy generally empowers market participants to decide for themselves whether to enter into contracts restricting their right to sell their shares.").
[70] *Joslin v. S'holder Serv. Group*, 948 F. Supp. 627, 631-32 (D. Tex. 1996).

2. Are The Restrictions Reasonable To Achieve A Legitimate Corporate Purpose?

The policy of restricting the number of record shareholders to avoid public company reporting and filing requirements is clearly a valid purpose under section 202(d). Not having to comply with the burdensome and costly filing and disclosure requirements is an obvious "statutory or regulatory advantage." Likewise, the Delaware Supreme Court expressly found that the alignment of the employees' interests with those of the company is a legitimate policy.[71] In the words of the Supreme Court, a company has a legitimate interest in "the employment of trained, competent and honest persons who can always be depended upon to protect the company's interests. Such persons can best be secured by providing them with an interest in the business . . . ."[72]

It is reasonable to conclude that CGC's purposes would not be achieved if the stock was transferable. First, transfer of the stock to a sufficiently large number of owners would destroy CGC's exemption from SEC regulations. A restriction on transfer is obviously reasonably related to this purpose. Second, restricting ownership interest in the stock to employees (or their immediate families) clearly aligns the interests of the employees with CGC. Having an ownership interest in the company gives the employees more of the benefits of the

[71] *Lawson*, 152 A. at 726.
[72] *Id.*

company's success, and more of the risks in the company's failure. Therefore, these restrictions are reasonably related to legitimate corporate purposes.

Ritter argues that the Requested Distribution would not violate the SRA's purpose of maintaining CGC as a private company. This is beside the point. The Requested Distribution would violate the restrictions contained in the SRA. These restrictions were adopted to serve the proper purpose of maintaining the company as a private company and are reasonably related to this goal. The restrictions need not be the least restrictive alternative that the board could adopt. They need only be reasonable.

Furthermore, Ritter was well aware of, and specifically agreed to, the restrictions on her interest in the stock, and she agreed that she could be divested of whatever rights she had in the stock at any time. The Trust is fully revocable by either Ritter or Armour, upon written notice.[73] Upon revocation of the Trust, the stock automatically transfers to Armour, and it cannot transfer to Ritter.[74] Ritter also signed numerous other documents restricting any rights or interests she has in

[73] *See* Trust Art. I.
[74] *See* Trust Amendment Art. IV, § F.

the stock.[75] Ritter cannot now disclaim the reasonableness of these restrictions, after agreeing to them time and time again.

In addition, Ritter argues that the SRA does not *really* restrict ownership to employees because it gives CGC the discretion to waive those restrictions and because the SRA contains several exceptions. However, even Ritter admits that the vast majority of stock (approximately 80%) is employee owned. And the vast majority of stock that is not employee owned is "grandfathered" stock, stock owned before the SRA was entered into and expressly provided for in the SRA. Furthermore, while Ritter makes a great deal about the fact that CGC has allowed charities to own stock, this too is provided for in the SRA. It is also relevant that, in every instance, CGC *bought back* this stock from the charity at the formula price, usually within a month of the time the charity acquired the stock, but never more than three months after.[76]

[75] *See* SRA § 2.1 ("No Stockholder shall sell, assign, transfer (whether by merger, operation of law or otherwise), dispose of or encumber any of the Stockholder's Shares or any interest therein except as specifically provided in this Agreement. Any purported or attempted sale, assignment, transfer, disposition or encumbrance of Shares or any interest therein not in strict compliance with this Agreement shall be void and shall have no force or effect."); Trust Amendment Art. IV, § F ("The Trustee shall not distribute or otherwise transfer [stock] to any 'Person' (as that term is defined in the [SRA]) (including a trust beneficiary) without the prior written consent of CGC, which consent may be granted or withheld in CGC's sole and absolute discretion."); the Joinder Agreement ("We [Armour and Ritter] understand that all stock certificates that we are acquiring as trustees have a restrictive legend and may not be sold, assigned, pledged or otherwise transferred except in accordance with the provisions of the [SRA] and state and federal securities laws.").

[76] De Toledo Dep. at 64:10-65:3.

In contrast, a transfer to Ritter is not expressly provided for in the SRA. CGC would have to exercise its discretion and make an exception for her. While CGC most likely has the discretion to do so, it has never allowed a transfer of stock pursuant to a divorce, and asserts that it never will. In fact, should CGC make an exception for Ritter in this case, it would be more difficult for it to claim that its policy of prohibiting such transfers is reasonable in a subsequent case.

Ritter also cannot credibly argue that CGC's retention of discretion to approve an otherwise prohibited transfer is itself evidence of unreasonableness. On the contrary, it is eminently reasonable to retain the ability to adjust policy to changing circumstances. Indeed, it would perhaps have been unreasonable if CGC had not retained discretion, but had it bound itself to *never* allow a transfer not in strict compliance with the SRA.

For the foregoing reasons, the court concludes that the restrictions on the transfer of stock contained in the SRA are reasonable.[77]

IV.

In connection with these proceedings, CGC has requested that it be awarded the reasonable attorneys' fees it incurred in bringing this action.

Section 10.16 of the SRA states: "In the event of litigation in connection with or concerning the subject matter of this Agreement, the prevailing party shall

[77] The issue of whether the formula price represents a fair value of the stock held in the Trust is not relevant to the issues raised and adjudicated in this action. The court, therefore, makes no ruling with respect to the value of the stock or the fairness of the formula price.

be entitled to recover all costs and expenses incurred by such party in connection therewith, including reasonable attorneys' fees."

Delaware follows the "American Rule" with respect to attorneys' fees. This means that litigants are generally responsible for paying their own counsel fees, in the absence of either statutory authority or a contractual undertaking.[78] However, when there is such a contractual provision, Delaware courts routinely enforce it.[79]

Ritter argues that the attorneys' fees provision should not be enforced against her because CGC could have waited until the divorce court decided how to distribute the community property. She claims that the California court's decision could have made this case unnecessary by, for example, requiring a buy-out of Ritter's community property interest in the stock.

The court is unpersuaded by this argument. Ritter herself tried to join CGC to the divorce proceeding. Had she been successful, CGC would have incurred many of the same costs that it incurred in this proceeding. Moreover, Ritter cannot now rely on the fact that the California court may award a buy-out, because she will not agree to a buy-out. Had she done so, CGC would have had no reason to bring this case.

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[78] *See Burge v. Fidelity Bond & Mortgage Co.*, 648 A.2d 414, 421 (Del. 1994); *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1164 (Del. 1989).

[79] *See, e.g.*, *Northwestern*, 672 A.2d at 44 (Del. 1996) (enforcing a clause for attorneys' fees in a hold-harmless agreement); *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del. 1992) (enforcing a clause for attorneys' fees in an indemnity agreement); *Cura Fin. Serv. N.V. v. Elec. Payment Exch., Inc.*, 2001 Del. Ch. LEXIS 132, at * 77 (Del. Ch. 2001) (enforcing a clause for attorneys' fees in an non-circumvention agreement).

Ritter also argues that any fees should be assessed against the Trust and not her. This is so because it is the Trust that is a party to the SRA, the contract that contains the provision requiring payment of attorneys' fees. The court agrees. It would violate the American Rule, and be inequitable, to require someone not a party to the SRA to be bound by its attorneys' fees provision. The Trust, therefore, is bound to compensate CGC for its reasonable attorneys' fees. The parties are directed to consult and try to reach agreement on the level of such award. In the event that the parties cannot agree, they are directed to seek the scheduling of a prompt hearing to decide that issue.

V.

For the above reasons, the court concludes that CGC is entitled to declaratory relief. The court therefore declares that the restrictions on stock transfer contained in the SRA bar the disposition of record ownership of the stock to Ritter, they bar the Requested Distribution, and they bar any disposition of any ownership right in the stock to Ritter, without CGC's express prior consent. The court further declares that the restrictions contained in the SRA are valid and binding. GCG's reasonable attorneys' fees in connection with this action will be assessed against the Trust. IT IS SO ORDERED.