Revisiting Stock Transfer Restrictions

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Stock transfer restrictions serve an important role for privately held corporations, but can also have negative implications for investors and individual stockholders. Corporations and those who invest in them, as well as employee recipients of equity in lieu of cash compensation, need to carefully consider the scope of such restrictions and the practical consequences of limiting transferability and liquidity. A recent Delaware Chancery Court decision in Henry v. Phixios Holdings Inc. stands as a reminder that care must be taken to properly effectuate stock transfer restrictions, and gives us reason to explore the practical implications of such restrictions on corporations and their stockholders.

What are Stock Transfer Restrictions and Why Have Them?

Privately held corporations typically control who may own the business through restrictions on the transfer of stock. There are many rationales for restricting ownership. Principals in the company may wish to limit who will be their partner in the business. This is particularly true where the company is family-owned or like-minded entrepreneurs have combined to pursue a shared vision. Allowing an outsider who does not share the same family values or business vision is unappealing to the original stockholders. Corporations, as well as venture capital and private equity funds investing in such companies, frequently use restricted stock as a retention tool for key employees. Most times, restrictions on transfer are coupled with vesting to incentivize key employees to remain with the company and contribute to the long-term success and growth of the company over time. As such, restrictions on transfer are intended to prevent employees from transferring stock after it has vested but before a liquidity event in which investors can realize a return on their investment. Companies also may want to prevent stock from being held by competitors.

The rise in secondary market trading of private company stock with the arrival of outlets like SecondMarket (now known as Nasdaq Private Market) and Sharespost has also contributed to the proliferation of broader stock transfer restrictions. These secondary markets allow holders of private securities to find buyers for their stock without the need for a public market. However, creating such liquidity can create unintended negative consequences for the issuer corporation beyond simply reducing the employment-related incentives discussed above.

What are the Consequences of Having Stock Transfer Restrictions?

For one, broad-based trading of private securities could result in a corporation “creeping public.” Where transfers result in the company having 2,000 or more stockholders of record, the company (if it has more than $10 million in assets) will be forced to register its securities and become a reporting company under Section 12(g) of the Securities Exchange Act of 1934, as amended. Becoming subject to such requirements can result in significant expense for a company and may involve premature disclosure of competitively sensitive information that a company would prefer to keep confidential.
Further, even if the company does not end up going public, the increase in the stockholder base from a few insider
employees and investors to a broad base of unrelated, unaffiliated parties can become unwieldy to manage; for example,
when needing stockholder approval of a sale or merger.

A larger stockholder base, particularly one that may not have full access to information because of the manner in which
they acquired their shares, may also lead to more opportunities for litigation against the company from disgruntled
investors claiming fraud or mismanagement. It also allows investment in the company by funds or other investors whom
the company intentionally excluded from investment for strategic or other reasons. Additionally, allowing sales and
trading in private securities can have implications for the valuation of the company as viewed by future investors, as well
as for purposes of pricing continuing equity grants to ongoing employees and advisers. Finally, in the course of venture
and private equity investment rounds, the investors negotiate approval requirements and thresholds based on the
capitalization of the company at the time of their investment. Allowing liquidity, even among the investment group, could
change the voting dynamics in an adverse, or at least unintended, manner such that a particular fund or funds no longer
have blocking rights without gaining the consensus of new third-party investors.

What are the Practical Considerations When Addressing Stock Transfer Restrictions?

As discussed above, transfer restrictions serve many beneficial purposes for corporations. However, many corporations,
and particularly venture-backed technology companies, have adopted very broad restrictions in their certificates of
incorporation or bylaws that restrict any transfers without consent from the board of directors. On the one hand, such
provisions allow room for the board to grant exceptions or exercise discretion so that they can justify the reasonableness
of the restriction and adjust policy as necessary during the company’s life cycle. However, some corporations have
adopted a policy of refusing any request for transfer because of a concern that a waiver in one case could set a
precedent or undermine the validity of their reasoning in the case of a subsequent request. This overly restrictive
restraint on trade has led to creative attempts in the marketplace to transfer derivative versions of the underlying
securities through contract rights. In a period where companies are taking longer to go public or engage in a liquidity
event such as a sale, it is also creating unrest among employees that hold a completely illiquid but nominally valuable
asset. This has led to some corporations considering interim buyback programs or other options to allow employees
some liquidity.

There are also cases of venture capital and private equity funds receiving stock in a merger or stock-for-stock exchange
as a result of a sale of a portfolio company where the consideration received is subject to such transfer restrictions. A
fund may be near the end of its life or need liquidity for other reasons and discovers that despite expecting a corporation
to act in a reasonable manner to permit a limited sale of what is likely a small holding, the corporation rejects any
request for permission to transfer the stock. Therefore, the fund is left with an illiquid asset and an inability to monetize
that asset for the benefit of its investors.

Conclusion

While stock transfer restrictions are a necessary and appropriate tool for corporations to use for the various purposes
discussed above, they can also create issues for a corporation and its stockholders if not properly implemented, or when
enforced in either an inconsistent or overly broad manner. With proper care, however, companies and stockholders can
avoid the pitfalls that can arise from the restrictions. It is advisable for those receiving stock, whether through an employee grant, investment, secondary market purchase or as a result of a merger or divestiture, to do appropriate diligence as to any transfer restrictions and negotiate in advance appropriate exceptions to any such restrictions in order to protect the value of their holdings.

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