

Stock Transfer Restrictions Should Be Conspicuously Noted, Delaware Chancery Court Opinion Reminds Issuers

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In Henry v. Phixios Holdings, Inc., C.A. No. 12504-VCMR, the Delaware Court of Chancery held that pursuant to Section 202 of the General Corporation Law, in order for a stockholder to be bound by stock transfer restrictions that are not “noted conspicuously on the certificate or certificates representing the security,” he must have actual knowledge of the restrictions before he acquires the stock. If the stockholder does not have actual knowledge of the stock transfer restrictions at the time he acquires the stock, he can become bound by the stock transfer restrictions after the acquisition of the stock only if he affirmatively assents to the restrictions, either by voting to approve the restrictions or by agreeing to the restrictions.

The Chancery Court concluded that the plaintiff did not have actual knowledge of the restrictions, though the restrictions were contained in the company’s bylaws provided to the plaintiff prior to his purchase of the company’s stock, and that as a result, the company could not rescind his shares pursuant to the restrictions contained in the bylaws.

Since it can be challenging to prove “actual knowledge,” issuers are reminded to place appropriate legends on their restricted securities prior to sale. With regard to book-entry shares, versus certificated shares, issuers should provide notice of such restrictions pursuant to Section 151(f) of the General Corporation Law. Issuers may also obtain an agreement, a vote or other evidence that purchasing securityholders accepted the applicable restrictions on transferability prior to sale.

Under the Securities Act, issuers are required to take steps to prevent distribution to the public of securities that are neither registered nor exempt from registration. Restrictions on transfer may also be required under an issuer’s charter documents or in an agreement with a stockholder. Common types of legends include:

- a “33 Act” legend that indicates that securities have not been registered under the Securities Act and may not be resold unless they are either registered or exempt from registration,

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- an "affiliate" legend for control shares held by directors, executives or large stockholders, and
- a "lockup" legend that indicates that a contract prohibits the stockholder from selling the shares for a period of time.