Managing Secondary Market Transactions With Transfer Restrictions

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The traditional approach of many venture capitalists has been to acquire a large equity stake in a promising start-up and to incentivize the start-up’s officers and employees in part by issuing them some stock or stock options in the company, with the intention (and hope) that these people will work harder to make the firm succeed because their economic interests would be aligned (for the most part) with those of the venture capitalist. The employees would have very few alternatives for selling their stock before the venture capitalist could.

However, in the past few years, “secondary markets” for private company stock have emerged and provided an opportunity for officers and employees to sell their equity before the VCs are ready for their exit. For example, in 2009, SecondMarket Inc. developed an online platform for trading equity and debt of private companies, and facilitating trades in restricted stock, unlisted or unregistered warrants, convertible debt and employee stock options. Trading on SecondMarket has been significant, with approximately $600 million worth of transactions in 2011. SharesPost, Inc. provides another outlet for holders of private company stock to find buyers. One source estimates that a total of $2.4 billion in private-share transactions took place in 2009, with that number almost doubling to $4.6 billion in 2010, and with anticipated growth to nearly $7 billion in 2011.

The opportunities for officers and employees to sell their stock raise several problems for the venture capital investor and the corporation itself. The ability to sell private company stock decouples the goals of the venture capitalist (who is likely unable or unwilling to sell a large block of stock into such a thin market) from those of the officers and employees (who may be less likely to focus on the long-term success of the firm when they can cash out their stake by selling into the online secondary markets). The firms, not subject to SEC reporting requirements, may find themselves supporting trades, often initiated by insiders, that are based on asymmetric information and could present the basis for fraud claims, set off public relations problems that might cut short promising careers, undercut the value of an IPO or prompt the corporation to consider going public earlier than would otherwise be advisable. Strangers to the firm—sometimes competing VCs who missed the first opportunity to invest—could become stockholders during the critical formative time for the firm: these strangers might be more likely to initiate derivative strike suits or to exercise a stockholder’s statutory right to inspect the corporation’s “books and records.” Perhaps most importantly, if these transactions result in the company having 500 or more stockholders of record, the company will be forced to register its stock with the SEC, thereby losing one of the principal advantages of being a private company. As a result of these concerns, VC-backed companies and the VC firms themselves have sought ways to protect themselves from the potential pitfalls.

Some are looking to the Delaware General Corporation Law (the “DGCL”) and the Delaware case law to supply the tools to control the effect of these secondary markets on start-ups. One tool is Section 202 of the DGCL, which allows restrictions on the transfer of securities. Since the [Delaware statute on transfer restrictions] clearly evinces a forceful legislative policy supporting needed transfer restrictions, the common law in Delaware should be liberally construed to sustain restrictions which the corporation and its stockholders deem appropriate.

Since 1967, the Delaware case law has generally upheld transfer restrictions. The statute itself has been amended in ways that reinforce the enforcement of transfer restrictions adopted by the parties. For example, in 1967, the DGCL provided that a transfer restriction adopted “for the purpose of maintaining” a company’s status as an S-corp. would enjoy the “conclusive”
presumption of reasonableness. The categories of transfer restrictions entitled to the “conclusive presumption” were expanded to include restrictions for the purpose of “maintaining any local, state, federal or foreign tax advantage to the corporation or its stockholders” and “maintaining any statutory or regulatory advantage or complying with any statutory or regulatory requirements under applicable local, state, federal or foreign law.”

Despite the modernization of Section 202, some practitioners were still concerned whether the common law overlay to transfer restrictions would make the benefits of transfer restrictions illusory. Fortunately, a Court of Chancery case—Capital Group Cos., Inc. v. Armour—has put some of this concern to rest.

**Capital Group Cos., Inc. v. Armour**

In Armour, The Capital Group Companies, Inc. required all persons purchasing shares of its common stock to sign a “Stock Restriction Agreement” (the “SRA”) that “preclude[d] the transfer of stock to any non-employee” of the company, and gave the company the right to repurchase shares if they were transferred to a non-employee in violation of the agreement. Though some shares issued prior to adoption of the SRA were not subject to these restrictions, employee Armour was subject to them and purchased common stock in his name subject to that restriction. Later, for tax reasons, Armour asked the company for permission to transfer all of his stock to a trust of which he and his wife, Ritter, were trustees. The company allowed the transfer, but only if the trust consented to a restriction prohibiting any transfer of the stock without the company’s prior written consent, “which consent may be granted or withheld in [the company’s] sole and absolute discretion.”

When Armour and Ritter divorced, Ritter sought in the divorce proceeding an award of a direct or indirect interest in the stock then held by the trust. Faced with the transfer restriction, Ritter argued that the transfer restriction was “unreasonable and, therefore, void as against public policy.” The company attempted to head this argument off by seeking a declaratory judgment from the Delaware Court of Chancery that the transfer restrictions were valid and enforceable. It argued that the restrictions were reasonable because they (1) “limit[ed] the number of shareholders in the company, so that [it] need not comply with the filing and disclosure requirements that federal securities law imposes on public companies” and (2) “align[ed] the interests of the employees with those of the company, thereby enabling greater returns.”

After reviewing the Delaware case law interpreting and applying Section 202, the Court of Chancery then laid out several important precepts:

1. The common law reasonableness inquiry into stock transfer restrictions survived the adoption of Section 202 in 1967.
2. “Delaware courts have been reluctant to invalidate stock restrictions because they are unreasonable.” As a result, the Court should review transfer restrictions from a “deferential” standpoint, honoring “the decisions of market participants when they decide to place restrictions on stocks.”
3. The “burden of proving that a stock restriction is unreasonable lies with the party contesting the validity of the restriction.”
4. The reasonableness of a transfer restriction will be reviewed on its face, rather than as applied to any one person.
5. “The restrictions need not be the least restrictive alternative that the board could adopt. They need only be reasonable.” Thus, a Delaware court should not invalidate a transfer restriction just because a more elegant solution might have been found.

Significantly, under subsection (d)(2) of Section 202, a transfer restriction that is imposed for the purpose of “[m]aintaining any statutory or regulatory advantage” is conclusively presumed to be for a reasonable purpose. Armour specifically discussed transfer restrictions designed to avoid registration with the SEC and, applying a “deferential reasonableness inquiry,” recognized that the company’s transfer restrictions were reasonably imposed to achieve the corporate purpose outlined in Section 202(d)(2):

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." . . . It is reasonable to conclude that [the company’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 [the company’s] exemption from SEC regulations. A restriction on transfer is obviously reasonably related to this purpose. . . . Therefore, these restrictions are reasonably related to legitimate corporate purposes.23

**Takeaway**

Section 202 of the DGCL, as interpreted by *Armour*, should provide wide latitude for a private VC-backed corporation to protect itself from the potential downsides of secondary markets by adopting transfer restrictions, and keeping them in place until it is time for an IPO. As in *Armour*, the transfer restriction might be written broadly to prohibit any transfer unless it receives prior written approval from the company’s board of directors, in its sole and absolute discretion. The board of directors would then be in a position to be aware of any attempt to sell stock before it occurs and to decide whether to permit the transfer.

**Concerns**

Some cautionary points should be kept in mind when considering whether, when and how to adopt transfer restrictions:

- **Mid-Stream Restrictions.** Delaware’s justification for transfer restrictions trumping the common law prohibition of unreasonable restraints on alienation is based on the idea that the corporation and stockholders should have freedom of contract to adopt restrictions that they consider appropriate. As a result, a stockholder may argue that transfer restrictions adopted after she has acquired the stock do not apply to her unless she consents to them. Creative legal counsel may be able to draft around such problems, but the difficulty of adopting mid-stream transfer restrictions, along with the logistical issues that would arise if some but not all stockholders are bound by transfer restrictions,24 could call for the adoption of transfer restrictions quite early in the life of the corporation, thereby setting the expectations of all stockholders at the outset.

- **Discretion.** It might be advisable to draft transfer restrictions in a way that leaves room for the board of directors, or a committee thereof, to grant exceptions. In *Armour*, the ability of the board to grant exceptions was an important element of the Court’s decision, as evident by its noting that “it is eminently reasonable to retain the ability to adjust policy to changing circumstances. Indeed, it would perhaps have been unreasonable if [the company] had not retained discretion, but had it bound itself to never allow a transfer not in strict compliance with” the SRA.25

- **Exercising Discretion.** The company should think long and hard before granting an exception and allowing a transfer to take place. The *Armour* Court explained that “[i]n fact, should [the company] make an exception for [the plaintiff] 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.”26

- **Locus of the Restrictions.** Transfer restrictions “may be imposed by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation.”27 These various sites for transfer restrictions carry with them various attributes. A restriction baked into the charter should clearly put potential stockholders on notice of the restriction, but it could be relatively difficult to amend later. Bylaw amendments may only bind stockholders who approve them. Many firms might decide that it is most appropriate for restrictions to be adopted via stockholder agreement,28 but stockholder agreements only apply to the parties thereto.29

- **Technicalities.** The restriction must be in writing and “noted conspicuously” on the stock certificate or contained in the notice to be sent to a holder of uncertificated stock.

- **Uncertainty.** *Armour* was decided by the Delaware Court of Chancery, not the Delaware Supreme Court, and it is possible that the Delaware Supreme Court could come out differently on the issues addressed by *Armour*. Moreover, *Armour* held that Section 202 did not eliminate the reasonableness inquiry from the common law, and, as a result, it is difficult to give clients absolute comfort that a transfer restriction will always be enforced. Given these factors, one could imagine a court of equity coming out differently than the Court did in *Armour* if faced with the right (or wrong) set of facts and circumstances.
Conclusion

The potency of transfer restrictions is acknowledged by SharesPost in its “Frequently Asked Questions” page, which warns a prospective seller that it must "identify any restrictions that apply to [its] shares, and to upload copies of the documents containing the restrictions." It is through these sorts of transfer restrictions that a corporation can control its own incubation and preserve the regulatory advantages of being a private corporation until such time as it decides to go public. Delaware's legislature and its courts understand the need for corporations to retain their regulatory and tax advantages and have crafted transfer restriction rules to accommodate them.

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Endnotes

3 See Dan Primack, “4 Questions for the Secondary Markets.” Fortune, May 11, 2011 (available online: http://finance.fortune.cnn.com/2011/05/11/4-questions-for-the-secondary-markets/ (“Imagin the one of the heavily-traded companies goes public at 30% lower than where it traded on the second market. And imagine the secondary market sellers were insiders. The buyers may well sue, arguing that the sellers should have known the shares were overvalued (remember, buyers almost never know the actual company financials).”); Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831, 837-38 (Del. 2011) (finding that a plaintiff need not establish actual harm to the corporation in order to state a claim for insider trading under Brophy v. Cities Service Co., 70 A.2d 5 (Del. Ch. 1949) and obtain disgorgement of a fiduciary’s profit associated with the trading).
5 “Stratim Buys Stake in Linden Lab.” Private Equity Hub, June 16, 2009 (available online: http://www.pehub.com/42270/stratim-buys-stake-in-linden-lab/) (quoting a managing partner of direct secondaries firm Stratim Capital as having purchased “almost the entire position of an existing shareholder” in Linden Lab, the maker of the Second Life virtual world that had raised around $19 million in VC funding from firms including Benchmark Capital, Catamount Ventures, Globespan Capital Partners and Omidyar Network; explaining that “I don’t think this is a company that anyone will be able to put new money into, because it doesn’t look like it will need to raise another VC round”).
6 8 Del. C. § 220 (providing stockholders with the right to inspect the books and records of a Delaware corporation for a “proper purpose”).
7 But see Ira Teinowitz, “SEC Advisory Offer Surprises on Shareholder Limit.” The Deal Pipeline, Feb. 1, 2012 (describing a February 1, 2012 meeting of the SEC’s small business advisory committee, at which the committee recommended that “the number of investors that a company can enlist before triggering full SEC filings be doubled from the current 500 to 1,000” and that this number should “exclude employees who own stock that can’t yet be traded”).
8 See, e.g., Steven M. Davidoff, “Facebook May Be Forced to Go Public Amid Market Gloom.” Dealbook, Nov. 29, 2011 (available online: http://dealbook.nytimes.com/2011/11/29/facebook-may-be-forced-to-go-public-amid-market-gloom/) (explaining that “Facebook will almost certainly have to go public [in the near term] whether it wants to or not—and whether or not it can get a valuation of $100 billion or more in doing so. And it’s partly Facebook’s fault—it just has too many shareholders”; noting that some employees sold stock in private markets without the company always exercising its right of first refusal).
9 Fletcher, Cyc. Corp. § 5455.
10 Compare Lawson v. Household Fin. Corp., 152 A. 723, 726 (Del. 1930) (finding that a right of first refusal charter provision granted to the company was a “reasonable restriction upon the transfer of stock . . . necessary and convenient to the attainment of the objects for which the corporation was incorporated” and reasonably related to the purpose of attracting and retaining “trained, competent and honest persons who can always be depended upon to protect the company’s interests”) with Greene v. E.H. Rollins & Sons, Inc., 2 A.2d 249 (Del. Ch. 1938) (invalidating a certificate of incorporation provision that would give the corporation an absolute right to repurchase, on demand and at a price fixed by a valuation formula, shares of common stock other than those issued upon exercise of preferred stockholders’ conversion rights, because the purported purpose of supporting stockholder “harmony” was not acceptable and because the restriction unreasonably amounted to an absolute prohibition on alienability of the stock except to the corporation).
The possibility that some, but not all, stockholders are subject to a transfer restriction should not invalidate the restriction for that reason alone. In *Armour*, some of the stockholders were “grandfathered” and were not subject to the restrictions outlined in the later-executed SRA. This meant that some stockholders were free to transfer their shares without restriction. Nevertheless, the restrictions were enforced on the stock held by a stockholder signatory thereto, regardless of the possibility that “grandfathered” stockholders may have been able to sell out to 500 stockholders in order to force SEC reporting obligations upon the company. *2005 WL 678564*, at *11.

*Id.* at *9.

See *Armour*, *2005 WL 678564*, at *9* (“Ritter was well aware of, and specifically agreed to, the restrictions on her interest in the stock . . . . Ritter . . . signed numerous other documents restricting any rights or interests she has in the stock. Ritter cannot now disclaim the reasonableness of these restrictions, after agreeing to them time and time again.”).


See *Armour*, *2005 WL 678564*, at *9*.

*Id.*

8 Del. C. § 202(b).

*Id.*

*Id.*

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