

Recent Delaware Court Decision Endorses and Enforces Stock Transfer Restrictions Even Though No Actual “Transfer” Occurred

By Frederic G. Hammond, Dimitry Herman and Andrew Rogovin

When is the last time you checked your restricted stock certificates and wondered about the stock transfer restrictions on the back? To what extent are these restrictions enforceable and what constitutes a prohibited “transfer” under a stock transfer restriction agreement? In a recent Delaware Chancery Court case, *The Capital Group Companies, Inc. v. Timothy D. Armour and Nina L. Ritter*, (March 15, 2005), the Court reaffirmed the right of companies and their investors to impose restrictions on stock transfers and clarified that contractual rights to receive proceeds of a sale of stock or dividends would constitute an assignment or disposition in violation of stock transfer restrictions.

In the Armour case, shares of The Capital Group Companies, a privately-held corporation (the “Company”) originally held by Timothy Armour, a senior executive of the Company, were transferred into a trust for the benefit of Armour and his wife, who was not a Company employee. The Company had previously consented to the transfer of the shares to the trust, subject to agreement by all parties that the trust would be bound by

the Company’s Stock Transfer Restriction Agreement.

As is commonly the case, the Agreement gave the Company the right to repurchase the shares in the event of a transfer, assignment, or disposition that would violate the Agreement.

After Armour filed for divorce in California (a community property state), his wife sought to obtain the benefit of an interest in the shares. Specifically, she requested the right to receive the dividends and net sale proceeds in respect of her portion of the shares, but did not request a direct distribution of shares.

Delaware Law

The Court first noted that Section 202 of the Delaware General Corporation Law requires that stock transfer restrictions be conspicuously noted on a stock certificate and in the charter or by-laws. In addition, such restrictions must serve a “reasonable purpose.”

“Reasonableness” of Restrictions

The Court then found that the restrictions in the Agreement were reasonable, because the following two main corporate purposes were served: 1) limiting the num-

ber of shareholders to avoid the filing, disclosure and other regulatory burdens associated with being a public company; and 2) keeping the shares in the hands of employees in order to motivate them and thereby provide a greater return to the Company. The Court also noted that the wife had signed several other documents acknowledging that the restrictions applied.

Right to Receive Proceeds Violates Agreement

Perhaps of more interest is the Court’s analysis in determining that the requested right to receive dividends and sale proceeds would constitute a violation of the Agreement. The wife argued that these rights would not violate the Agreement because:

- she would receive no ownership interest in the shares; and
- there would be no transfer of the shares as defined in the Agreement.

The Agreement stated that “no stockholder shall sell, assign, transfer, dispose of or encumber any of the stockholder’s shares or any interest therein except as specifically provided in this Agreement.” The wife argued that she

About the authors

Frederic G. Hammond, Dimitry Herman and Andrew Rogovin are partners in Hinckley Allen’s corporate and business law department. Our global practice concentrates on public company compliance, venture capital and private equity transactions, mergers and acquisitions, strategic licensing and other corporate and securities matters, with a focus on the information technology, telecommunications, network systems, wireless, health care, life sciences and consumer product sectors.

For more information on this article or Hinckley, Allen & Snyder, please contact Frederic G. Hammond at (617) 378-4260 or fhammond@haslaw.com

would have only an interest in the executive/husband's assets directly commensurate with and dependent upon the proceeds he received from the stock. However, the Court ruled that such a right would constitute an ownership "interest" prohibited by the Agreement. In addition, although the requested benefits would not constitute a "transfer" since the Agreement defined a "transfer" as "a transfer of record of shares as reflected in the stock books of the Company," the Court noted that the Agreement also precluded "dispositions and assignments," which were not specifically defined in the Agreement. Most importantly, the Court concluded that awarding the wife the right to a share in the dividends paid on the stock and proceeds from its sale would qualify as both a *disposition* and an *assignment* and would therefore violate the Agreement.

Practical Considerations

Delaware corporations seeking to enforce stock transfer restriction agreements should consider the following:

- state in the investor rights, shareholders or other stock transfer restriction agreement and possibly in board minutes relating to its adoption that the restrictions are deemed to be reasonable and in the best interests of the corporation.
- recite possible corporate interests that such provisions might serve, such as limiting the number of stockholders such that public company status is not achieved, and keeping stock in the hands of employees.
- enforce stock transfer restrictions in an evenhanded and consistent fashion.
- ensure that restrictions are conspicuously legended on stock certificates and are contained in the charter or the by-laws.
- include broad language defining prohibited transfers, as was the case here. (Without the words "disposition" or "assignment", the Court would likely have ruled that the grant of the interests requested would not violate the Agreement.)

Delaware shareholders who wish to grant rights relating to restricted shares should carefully evaluate whether the grant would constitute a violation of applicable stock transfer restrictions, resulting in an unplanned repurchase or redemption of the shares by the company.

About Hinckley, Allen & Snyder LLP

Hinckley, Allen & Snyder LLP, with over 110 lawyers in three New England states, provides a broad range of legal services to regional, national and international clients. Our practice includes public company compliance and corporate governance, corporate and securities law, venture capital and private equity deals, mergers and acquisitions, commercial lending, intellectual property, health care, real estate, construction, litigation and tax. Our clients include major commercial banks, hospitals and health care institutions, technology start-ups, private equity funds, broker-dealers and a variety of publicly and privately-held companies.

This alert is provided with the understanding that it does not constitute the rendering of legal, tax or other professional advice or services by Hinckley, Allen & Snyder LLP or an affiliate or their attorneys. This alert may be considered an advertisement for legal services.