Delaware Court of Chancery Ruling Underscores the Importance of Noting Transfer Restrictions on Stock Certificates

In *Henry v. Phixios Holdings, Inc.*, the Delaware Court of Chancery found that restrictions on the transfer of stock that were not noted on the certificates representing such stock were unenforceable against a stockholder that did not have knowledge of the restrictions at the time the stock was issued. The court found that for a stockholder to be bound by transfer restrictions that are not conspicuously noted on the certificate representing his stock, the stockholder must either: (i) have actual knowledge of the restrictions before he acquires the stock or (ii) affirmatively assent to the restrictions after he acquires the stock, either by voting to approve the restrictions or agreeing to the restrictions.

In *Henry,* a stockholder agreement was adopted by Phixios Holdings, Inc. ("*Phixios*") and its stockholders at that time that placed certain restrictions on Phixios stock, including that a stockholder's stock could be revoked by Phixios by a majority vote of the stockholders in circumstances in which the stockholder was found to be engaging in certain conduct that was competitive with Phixios or otherwise harmful to Phixios' interests. Subsequent to the adoption of the stockholder agreement, Phixios hired Jon Henry ("*Henry*") and as part of his compensation package issued him 50,000 shares of Phixios stock. At the time the stock was issued to Henry he was not provided with anything in writing that reflected the restrictions on his stock and the restrictions were not noted on the certificates representing Henry's stock. Phixios claimed that its Chief Operating Officer explained the restrictions to Henry over the telephone at the time the stock was issued, which Phixios said was its common practice when it issued new stock. Henry disputed this claim and testified that no such explanation ever took place. At a date following the issuance of Henry's Phixios stock, the Chief Operating Officer of Phixios emailed all the stockholders, including Henry, a copy of the stockholder agreement. Henry did not at that time or at any time thereafter assent to the restrictions found in the stockholder agreement. Henry was later fired and Phixios attempted to revoke his shares of stock alleging Henry engaged in competitive or otherwise harmful conduct to Phixios.

The court found that the restrictions set forth in the stockholder agreement were not enforceable against Henry's stock in Phixios. Section 202(a) of the General Corporation Law of the State of Delaware ("*DGCL*") provides that unless noted conspicuously on a certificate representing a security, a restriction is ineffective except against the person with actual knowledge of the restriction. Section 202(b) of the DGCL provides that a restriction may be imposed by the certificate of incorporation, bylaws or agreement among stockholders and specifies that no restriction shall be binding upon a security issued prior to the adoption of the restriction unless the holder thereof is a party to the agreement or voted in favor of the restriction. Reading Section 202(a) and (b) holistically, the court held that an existing restriction on the transfer of stock is binding on a subsequent purchaser if (1) it is noted conspicuously on the certificate representing the stock; (2) the stockholder has actual knowledge of the restriction at the time he acquires the stock; or (3) the stockholder consents to be bound by the restriction either through a vote or through a subsequent agreement with the stockholders or with the company. The court noted that to allow otherwise would allow a corporation to sell stock to an investor with the expectation that transfer was unrestricted while at the same time withholding the existence of potentially value-reducing restrictions. Because the restrictions were not noted on the certificates representing Henry's stock and Henry did not consent to the restrictions, Phixios was required to show that Henry had knowledge of the restrictions at the time the stock was issued. Phixios was unable to meet this burden as the court found Henry's testimony regarding whether or not the restrictions were explained to Henry over the telephone at the time of issuance to be more credible than the testimony of Phixios' Chief Operating Officer.

The decision in *Henry* underlines the importance for an issuer to ensure that restrictions applicable to a security are clearly noted on the certificates representing the security. Absent restrictions appearing on a certificate, in order for the restrictions to be enforceable against a security holder, an issuer would need to either obtain the purchaser's consent to the restrictions, which will likely to be difficult to obtain given the restrictions likely adverse effect on the value of the security, or show that the purchaser otherwise had knowledge of the restrictions at the time the stock was issued. As the court's decision in *Henry* shows, proving that a stockholder had knowledge of restrictions at the time of issuance can be a difficult hurdle for an issuer.

For More Information

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