

Legend has it

How to use stock legends properly to prohibit unwanted transfers of shares

A legend is a statement on a stock certificate that notes restrictions on the transfer of the stock. A great deal of time and thought is put into preparing agreements among shareholders of closely-held companies, especially with regard to the transferability of share provisions. But if the final administrative step at the end is not taken, the restriction may be useless against a third party without knowledge of the restriction.

“Shareholders may agree to restrict the transfer of shares of a company’s stock, but if the restriction is not properly included on the stock certificate, the restriction on transfer could potentially be ineffective,” says Ashleigh M. Morales, an attorney with Semanoff Ormsby Greenberg & Torchia, LLC.

Smart Business spoke with Morales about stock legends and the impact of not properly including them on stock certificates.

Why is a legend important?

Typically, in privately held companies, shareholders will agree to restrict the transfer of stock in the bylaws, a shareholders’ agreement or a buy-sell agreement. Shareholders generally want to restrict the transfer of stock because they want a say in who will be running or owning the business with them. They may not want their fellow owners’ children, spouse or friends running the business with them in the event of an untimely death. In most situations, the other shareholders (or at least a majority of them) have to agree to the transfer of a shareholder’s shares.

What happens if the stock certificate does not include the legend?

Even if all the shareholders agree to a

restriction on the transfer of shares, if a third party receives a stock certificate without a legend containing the restriction and without actual knowledge of the restriction, that third party may not be bound by the restriction and may become the owner of the shares against the will of the other shareholders.

Pennsylvania law provides that unless a restriction is noted conspicuously on the stock certificate a restriction will be deemed ineffective except against a person with actual knowledge of the restriction. The legend puts the world on notice that the restriction exists so someone cannot claim they were unaware of the restriction. Most shareholders’ agreements provide that a legend must be included on stock certificates and the legend on the stock certificate should match that language.

How might this affect a company?

Let’s say an owner dies and all of his property passes to his children. And his children find his stock certificates without any legend on them but the deceased owner had agreed to a restriction on the transfer of shares in the shareholders’ agreement. Assuming the children were unaware of the restriction, the restriction would be ineffective as to the children and they would become the owners of those



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shares. This is a result the deceased owner and his fellow business owners most likely did not intend. And it becomes an even bigger issue if the restriction allowed the company to redeem the shares at a value less than fair market since now the children could demand fair market value for the shares. This could come at a significant cost to the company or the other shareholders in terms of the price to be paid or litigation.

Do shares of a company have to be certificated?

Generally, Pennsylvania does not require shares to be certificated — a company’s Articles of Incorporation will provide whether the shares are certificated or uncertificated. If shares are uncertificated, the company is required to provide the owner of the shares with written notice of the information typically contained on the certificate, including any restrictions on transfer.

Are LLC interests certificated?

Interests in limited liability companies may also be certificated or uncertificated. If certificated, any restrictions on the transfer of a limited liability company interest should be handled like shares of a corporation. ●