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The Stock Issuer's Dilemma: How Duties to Shareholders Limit an Issuer's Options in Employee Disputes

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When a dispute arises between a stock issuer and its former employee who owns restricted shares of the company's stock, the company may be tempted to use its powers as issuer to gain leverage in the dispute. For example, the former employee may want to sell restricted stock while the issuer may not want to facilitate such a sale until the dispute is resolved. But the law sharply circumscribes an issuer's ability to stop or delay share transfers in a dispute. In particular, an issuer's authority to decline to register a stockholder's share transfers are limited -- even when the stockholder may have engaged in fraud. As a result, in disputes with former employees who own restricted stock, a corporation must observe substantial restraint in exercising its powers as stock issuer. Those restraints are the subject of this article.

Illustrating the Dilemma

Two hypotheticals demonstrate just how narrow is an issuer's authority to use its stock registration powers to prevent or delay a former employee in transferring her restricted shares.

Scenario #1: James Holding Company acquired Bundy Tool and Die in a stock-for-stock merger. In the year after the merger, Bundy turned only a meager profit. The rosy forecasts of Bundy's former owners faded fast as, one by one, they resigned from James.

Fueled by the suspicions of James' board of directors, you, as general counsel, begin an investigation. The preliminary results cast serious doubt on the accuracy of certain financial information Bundy's former principals provided in the merger. The scent of fraud seems hard to ignore.

At just this moment, two recently departed Bundy vice presidents submit requests to sell some of the restricted James stock they received in the merger. Restricted stock is stock that the issuer has not registered with the United States Securities and Exchange Commission (SEC) under the Securities Act of 1933, 15 U.S.C. § 77a, *et seq.* (the 1933 Act). Section 5 of the 1933 Act, 15 U.S.C. § 77e, provides a general bar on sales of unregistered securities, while Section 4, 15 U.S.C. § 77d, states certain exceptions to Section 5's registration requirement. For convenience, this article refers to securities registration under the 1933 Act as "public registration" and to the registration of stock transfers on the books of the issuer or its transfer agent as "transfer registration."

To return to our illustration, the Bundy vice presidents have submitted sale paperwork that appears on its face to be in order. Included among these papers are attorney opinion letters stating that the proposed stock sales would not violate the securities laws. Surely, though, the former VPs ought not to be able to sell their stock and abscond with the bounty of a possible fraud.

You consider James' possible courses of action. The company might refuse to honor the former VPs' requests to register the sales of their shares, pending the completion of your investigation. But, this course is merely defensive; it would obtain no affirmative relief for James as the wronged party.

You settle on a more aggressive course that holds the promise of getting something back for James. If your investigation finds a fraud, James not only will refuse to register the former VPs' share transfers, but also will sue Bundy's former principals. The suit will claim that James paid too much for Bundy because of the sellers' fraud and will also allege breaches of the merger agreement. Because the Bundy acquisition cannot be unwound, James will seek damages, not rescission. Bundy and its assets still have value to James -- but at a lower price than that paid in the merger. Essentially, your damages suit will seek to re-value the Bundy acquisition. Pending its conclusion, the former VPs will not be allowed to sell their remaining shares.

Scenario #2: Jeremy Langdon had been brought into Dunedin Corp. to increase its share of the market for high-end powerboats. Historically, sales at Dunedin had grown slowly. Dunedin ran in the black, but its stock was thinly traded and overlooked.

Jeremy had a track record of boosting sales at two previous luxury item companies. Dunedin hired Jeremy under a three-year employment contract that provided a base salary and generous commission and, upon commencing work, shares of restricted stock.

During his first year at Dunedin, Jeremy proved to be a phenomenal asset. Dunedin's market share grew by over four percent. The company's stock began to attract interest. Almost as quickly, however, Jeremy appeared to lose interest. In the first quarter of his second year, he missed a few key meetings and sales growth slowed a bit. During that quarter, Jeremy took advantage of the modest run-up in Dunedin's stock price to sell half of his restricted shares in sales under SEC Rule 144, 17 C.F.R. § 230.144. Rule 144 allows sales of specified amounts of restricted shares beginning one year, or several years, after the shareholder received them from the issuer, as and when various conditions are met.

In the second quarter of Jeremy's second year, Dunedin's sales growth stalled entirely. At mid-year, Jeremy announced his resignation from Dunedin. About this time, his lawyer submitted a request to Dunedin to allow him to sell Jeremy's remaining shares under Rule 144, along with an attorney opinion letter and other documents supporting the requested sale.

Jeremy received his stock under a contract that called for him to work for Dunedin for three years. At his resignation, however, Jeremy had worked for Dunedin for only half of that time. You instruct Dunedin's transfer agent to decline to remove the restrictive legend from the remaining half of Jeremy's restricted shares, preventing Jeremy from making further sales under Rule 144. You wait to hear from Jeremy's lawyer and start to calculate the proper tribute to demand from Jeremy.

However intuitive these courses of action may seem they are more likely to add to a stock issuer's problems than to solve them. As discussed more fully in the next section of this article, under Article 8 of the Uniform Commercial Code (UCC), when a holder of securities submits share transfer paperwork that is properly endorsed and conforms with certain formal other requirements, an issuer that seeks to prevent a stock sale generally must either enforce an express *contractual right* to stop the transfer, or prosecute a claim to *rescind* its own prior sale of the securities to the stockholder. In all events, the issuer risks liability to the stockholder under the UCC for unreasonably delaying or refusing the requested transfer.

Thus, in the two hypotheticals discussed above, the refusals by James and Dunedin to register their former employees' requested share transfers on their own books (i.e., transfer registration) would expose each company to a suit for (a) injunctive relief and (b) damages accruing from any subsequent decline in their stock's price. Ironically, James' and Dunedin's efforts to gain leverage over their former employee-shareholders could have the reverse effect.

As shown in the final section of this article, an issuer's options can be similarly circumscribed when a former employee asserts a contractual rather than a statutory right to sell his or her restricted stock. For example, an employment or merger agreement under which an employee obtained restricted stock may state conditions under which the issuer is obligated to facilitate requested securities sales. If the former employee invokes such a contractual right then the issuer can generally stop a requested sale by seeking to rescind its own stock sale to the former employee.

Yet, rescission -- unwinding a business transaction -- oftentimes is not an attractive or feasible option. Moreover, an issuer's contractual duty to facilitate a former employee's stock sales may be deemed an independent obligation that must be satisfied even if the former employee breached other terms of the same contract, although the law is not settled on that point.

Nevertheless, careful drafting of the contract and restrictive legend may enable the issuer to condition its obligation to facilitate share transfers on the former employee-shareholder's compliance with his contractual and fiduciary duties to the issuer. On the other hand, absent well-crafted contract language, an issuer's rights to delay or entirely avoid a contractual obligation to register a transfer may be limited. Indeed, in a dispute with a former employee, a company may find that its statutory or contract duties as issuer substantially tie its hands in dealing with the former employee's stock sales.

Statutory Limits on Stopping Share Transfers

Issuers owe a duty under Section 8-401(a) of the UCC to register a requested securities transfer on the issuer's books once certain statutory conditions are met. UCC § 8-401(a) provides:

> If a certificated security in registered form is presented to an issuer with a request to register transfer or an instruction is presented to an issuer with a request to register transfer of an uncertificated security, the issuer shall register the transfer as requested if:

1. under the terms of the security the person seeking registration of transfer is eligible to have the security registered in its name;
2. the endorsement or instruction is made by the appropriate person or by an agent who has actual authority to act on behalf of the appropriate person;
3. reasonable assurance is given that the endorsement or instruction is genuine and authorized (Section 8-402);
4. any applicable law relating to the collection of taxes has been complied with;
5. the transfer does not violate any restriction on transfer imposed by the issuer in accordance with Section 8-204;
6. a demand that the issuer not register transfer has not become effective under Section 8-403, or the issuer has complied with Section 8-403(b) but no legal process [e.g., an injunction] or indemnity bond is obtained as provided in Section 8-403(d); and
7. the transfer is in fact rightful or is to a protected purchaser.

The provisions of Section 8-401(a) differ modestly as enacted by certain states. In sum, however, under UCC Sections 8-401(a) and 8-403, an issuer may not "unreasonably" delay or refuse a requested transfer registration if: (a) the shareholder's request meets the specified formalities (such as endorsement by an appropriate person); (b) a third-party has neither obtained an injunction to prevent the transfer nor posted an indemnity bond that protects the issuer against liability for refusing the transfer; and (c) the transfer is "rightful." Further, if an issuer is under a duty to register a transfer and fails or refuses to do so, or unreasonably delays in registering the transfer, then the issuer is liable, under Section 8-401(b) of the UCC, for a stockholder's resulting damages.

Moreover, the option under UCC Section 8-403 to obtain an injunction or post an indemnity bond to stop a requested share transfer belongs to third-parties, not issuers. Thus, where a shareholder submits transfer papers that are proper in form, the principal statutory avenue available to an issuer that desires to delay or refuse a transfer registration is to claim, under Section 8-401(a)(7), that the proposed transfer is not "rightful."

Yet, it is not difficult to make a facial showing that a proposed transfer of restricted stock is rightful. For example, issuers have argued that a share transfer requested by a former employee is not rightful because he or she engaged in misconduct that may expose the issuer to civil or criminal liability for securities fraud if it registered the transfer. As shown below, however, courts generally reject an issuer's claims that a transfer is not "rightful" where a former employee presents an attorney opinion letter, or SEC no-action letter, to the effect that a proposed transfer of restricted stock would not violate the securities laws. This is true even though such attorney opinion letters may assume the truth of the seller's representations, including that the seller does not possess material non-public information. Courts have reasoned that issuers face no exposure to criminal or civil fraud liability in registering the requested stock transfers because the issuer acts merely as a "conduit" for the shareholder's sales.

A second, more promising ground that issuers have raised to contend that a requested share transfer is not rightful is that the agreed consideration for the restricted shares was not fully and timely paid. Rule 144 provides that restricted securities must be held for a period of one year, or longer, from the date when consideration for the shares was fully and timely paid.

Cases decided both prior to enactment of the UCC, and under its provisions, illustrate these principles. Indeed, several pre-UCC cases continue to resonate and be cited. Moreover, common law cases may continue to have precedential value in those jurisdictions that hold that Section 8-401 of the UCC did not displace all common law causes of action concerning refusals or delays in registering a requested share transfer.

The seminal common law case is *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965). The defendant issuer had terminated the plaintiff's employment. Thereafter, plaintiff sought to dispose of unregistered shares of the defendant's stock, which plaintiff had bought from defendant's president. Plaintiff submitted both an attorney opinion letter and an SEC no-action letter, each stating that he was free to transfer the stock without registering it under the 1933 Act. Notwithstanding the opinion letter and SEC no-action letter, at the president's direction, the issuer ordered its transfer agent not to transfer the plaintiff's stock. Plaintiff sued the issuer and its transfer agent in federal court in New Jersey, alleging that they had converted his stock.

The *Kanton* court held that the defendants could not refuse to register the transfer based on their asserted fear of criminal liability. The court held that neither the 1933 Act nor the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.* (the 1934 Act), posed potential criminal liability for the issuer. Accordingly, the court rejected the issuer's argument that transfer registration could make an issuer criminally liable under Section 24 of the 1933 Act, 15 U.S.C. § 77x, for a willful violation of the public registration requirements of Section 5 of that Act.

A second pre-UCC case also merits discussion. In *Riskin v. Nat'l Computer Analysts, Inc.*, 308 N.Y.S.2d 985, 986-87 (N.Y. App. Div. 1970), *aff'd as mod'd on other grounds*, 326 N.Y.S.2d 419 (N.Y. App. Div. 1971), the court held that an SEC no-action letter relieved an issuer of any responsibility to ensure that its registration of a share transfer would not assist a criminal act. In *Riskin*, the plaintiff was a former employee of the defendant who sought to facilitate a share transfer by compelling the corporation to reissue certain shares without a restrictive legend. The legend prohibited transferring the shares without either (a) registering them under the 1933 Act or (b) obtaining an opinion of company counsel that public registration was not required. Plaintiff supplied the issuer and its transfer agent with an SEC no-action letter to the effect that the shares could be transferred without public registration. Nevertheless, the issuer's counsel refused to provide an opinion letter and even sought, unsuccessfully, to convince the SEC to rescind its no-action letter. Although the SEC confirmed its no-action letter, the issuer argued that it was reasonable for it to satisfy itself that if it allowed the requested transfer it would not be participating in a criminal act.

The court disagreed and held that the SEC no-action letter protected the issuer from any penalty for a willful violation of Section 24 of the 1933 Act. Likewise, the court ruled that the issuer had no civil liability under Section 12 of the 1933 Act, 15 U.S.C. § 77l, for selling securities by means of a prospectus or oral communication that makes an untrue statement of material fact or a misleading omission. According to the court, if the issuer granted the former employee's requested transfer then the issuer would have acted "*merely as a conduit* for the transfer of the shares without participating in any manner in the *sale*." (Emphasis added.)

A Delaware Chancery Court opinion, *Bender v. Memory Metals, Inc.*, 514 A.2d 1109 (Del. Ch. 1986), is an influential decision under the UCC. It illustrates the difficulty of establishing that a registered stock transfer is not "rightful" under Section 8-401 of the UCC. The plaintiff had bought 100,000 shares of unregistered stock from the issuer's chief executive officer. The shares bore a restrictive legend that prohibited transferring them unless (a) they were publicly registered under the 1933 Act or (b) the issuer received an acceptable opinion of counsel stating that the shares were exempt from public registration. Plaintiff sought to sell the shares under Rule 144 and asked for the issuer's counsel to provide the necessary opinion letter. But, the issuer's CEO denied that the plaintiff owned the shares and claimed that the plaintiff's husband had failed to provide certain financial services to the issuer, which the CEO contended was consideration for the shares issued to plaintiff. The CEO sued the plaintiff, alleging breach of contract and fraud and seeking damages and a return of the shares.

The issuer then refused to issue the requested opinion letter, stating that the CEO's pending claim precluded such a letter because Rule 144 required full consideration to be paid two years before the restricted shares could be sold. (The comparable holding period under Rule 144 is now one year.)

Plaintiff's counsel responded by authoring two successive opinion letters asserting that, regardless of the CEO's claim, the plaintiff's sale would be exempt from public registration. The issuer rejected each letter as not being "acceptable to the company," claiming that if the CEO owned the shares, rather than the plaintiff, then the requested transfer registration could expose the issuer to civil and criminal liability under the 1933 Act.

Plaintiff responded by suing the issuer to compel it to provide her a clean share certificate with no restrictive legend. The court granted this relief, holding that the issuer had no reasonable fear of liability under the 1933 Act. Regardless of the stock ownership dispute, the court reasoned that the evidence the issuer possessed, including the opinion letter, established that plaintiff was not an "issuer," "dealer," or "underwriter" and, thus, the sale was exempt from public registration under the 1933 Act.

The court reasoned that an issuer may rely on an opinion of counsel because its author has greater familiarity with the facts and assumes the risk of liability for a negligent opinion. Therefore, even if the transfer violated the 1933 Act, the defendant issuer faced no possible criminal liability because the violation would not have been "willful." The court also held that the issuer could not face civil liability under Section 12 of the 1933 Act where it had acted simply as a "conduit" for a stock transfer, citing *Riskin*. In particular, the issuer could not be held liable under Section 12 for mere negligence; instead, such liability required that the issuer have participated in the underlying violation knowingly and substantially. The court reasoned that an issuer who relies in good faith on a stockholder's sworn statement and an opinion of counsel cannot violate the 1933 Act knowingly or willfully. Accordingly, the court rejected the issuer's defense that the transfer was not "rightful" under Delaware UCC Section 8-401(e).

More recently, in *Netwolves Corp. v. Sullivan*, No. 00 Civ. 8943 & 9628, 2001 WL 492463, at *2-4, 9 (S.D.N.Y. May 9, 2001), the court ordered the issuer to instruct its corporate counsel to issue an opinion letter stating that five former employees of a subsidiary could lawfully transfer their restricted stock. The plaintiff-former employees had received the restricted stock when they merged their company into defendant's subsidiary. The share certificates bore a legend stating that they could not be transferred without either (a) public registration or (b) an opinion from the issuer's counsel stating that the transfer was permissible.

A dispute arose between the issuer and the plaintiffs over the subsidiary's financial performance. The plaintiffs wanted to sell their restricted shares and asked the issuer's counsel to prepare the opinion letter. The issuer's counsel refused. In justifying this refusal, the issuer did not rely on the subsidiary's disappointing financial performance. Instead, the issuer refused to cause its counsel to issue the opinion letter because: (a) the issuer had filed suit to rescind the merger pursuant to which plaintiffs received their shares; and (b) the proposed sales allegedly violated certain quantity limitations in Rule 144. The court rejected both arguments and ordered the issuer to instruct its counsel to issue the letter. The court cited its contemporaneous dismissal, on jurisdictional grounds, of the issuer's rescission claim. The court also held that any violation of the quantity limits in Rule 144 would not justify a refusal to issue the opinion letter but would warrant only a limitation on the volume of permitted sales. Finally, the court found that because the issuer was nearing insolvency, irreparable harm justified requiring the issuer to instruct its counsel to issue an opinion letter allowing the plaintiffs to sell the permitted volume of shares.

UCC Section 8-401 and these cases establish that when a shareholder presents, in proper form, both (a) share transfer paperwork and (b) an opinion letter stating that the transfer would comply with applicable securities laws, the issuer typically has no statutory or common law right to prevent the proposed share transfer unless one of a few potential exceptions applies.

The first exception arises under UCC Sections 8-401(a)(6) and 8-403(d) where a third-party procures either an injunction preventing the transfer or an indemnity bond protecting the issuer against liability for refusing the transfer. A second exception may prevent a share transfer if the issuer sues to rescind the contract under which the shareholder acquired the restricted shares. If the issuer fails to win its rescission claim, however, then it may be liable for any damages the delay causes the shareholder.

Third, an issuer that restates its financial statements may be entitled, and indeed required, to reacquire (or "clawback") restricted securities, or the proceeds thereof, from a former executive officer or other highly compensated employee. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the 1934 Act, 15 U.S.C. § 78j-4, to require a clawback of certain "incentive based compensation" in the event of a financial restatement. It is an open question whether restricted securities, or the proceeds thereof, may constitute such incentive based compensation. Clawback provisions were also included in the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243(a), and the Emergency Economic Stabilization Act of 2008 (establishing "TARP"), as amended, 12 U.S.C. § 5221(b)(3)(B). But, the Sarbanes-Oxley clawback provision is not enforceable by a private right of action. *See, e.g., Cohen v. Viray*, 622 F.3d 188, 194 (2d Cir. 2010). Similarly, it may be doubted whether the clawback provisions in Dodd-Frank and TARP are enforceable by private rights of action.

There is a fourth circumstance that may allow an issuer to prevent a former employee from transferring shares: if the issuer holds and exercises a clear contractual right to stop the requested transfer. It is to that subject that we now turn.

Contract Duties Relating To Transfer Registration

An issuer's duty to register a stock transfer may arise not only from the UCC, but also from the issuer's contractual obligations. For example, an employment or merger agreement may (a) provide restricted stock to new employees or to sellers of an acquired entity and (b) state conditions under which the issuer is required to register a requested share transfer. The contract also may authorize the issuer to decline a requested transfer registration under specified circumstances. In either situation, case law demonstrates that: (a) courts are reluctant to recognize an issuer's right to bar a shareholder from transferring restricted shares, even when the issuer and shareholder are engaged in a dispute; and (b) an issuer that wants to prevent a former employee from selling restricted stock, as a practical matter, must have a clear contractual right to prevent the transfer or a sound basis for rescinding its sale of the stock in question.

As an initial matter, contractual restrictions on a former employee's rights to transfer shares must be express. For example, in *Catherines v. CopyTele, Inc.*, 602 F. Supp. 1019, 1021-23, 1026-27 (E.D.N.Y. 1985), the defendant-issuer refused to allow the plaintiffs to sell their restricted shares although the Rule 144 holding period had passed. The issuer argued that it was an *implied* condition of plaintiffs' share transfer rights that plaintiffs remain employed by the issuer. The court found no support for the alleged restriction on plaintiffs' transfer rights and enjoined the defendant-issuer from interfering with plaintiffs' sales of stock.

Even when an issuer has an *express* contractual right to prevent a former employee from transferring shares, the issuer may not exercise that right if it has breached the contract. In *Steranko v. Inforex, Inc.*, 362 N.E.2d 222 (Mass. App. Ct. 1977), the plaintiff, a former company executive, had acquired 24,000 restricted shares under his employment agreement. Plaintiff had contracted not to sell his stock for five years and to allow the issuer to repurchase the shares at cost if he was discharged for cause. After plaintiff was demoted, he sought a judicial determination that he had been constructively discharged. He also refused to assign certain patent rights, as called for in his employment agreement. Citing that refusal, the issuer discharged the plaintiff for cause and sought to repurchase his restricted shares at cost. When the plaintiff refused to sell the shares back, the issuer sued, seeking their return.

In response, plaintiff demanded that the issuer and its transfer agent issue certificates for most of his shares without a restrictive legend. But the transfer agent, on instructions from the issuer, declined to issue clean certificates. Plaintiff then brought another suit, seeking damages from the issuer, its president and the transfer agent for refusing to lift the restrictive legend. The three cases were then consolidated.

The trial court and appellate court each held that by demoting plaintiff the issuer had breached the employment agreement. The trial court further held that the stock restrictions in the issuer's favor remained enforceable despite the issuer's breach. But the appellate court disagreed. It held that the issuer's breach rendered unenforceable the employment agreement's restrictions on the former employee's right to sell his stock, as well as the issuer's contractual right of repurchase. Accordingly, the court ordered the restrictive legends removed from the plaintiff's share certificates and held plaintiff was entitled to damages for the delay in allowing the stock sale. In sum, the *Steranko* court held that an issuer's breach of contract deprived the issuer of the power to enforce express contractual restrictions on a former employee's right to sell shares.

Yet, the converse is not necessarily true -- courts have split on whether a restricted shareholder's contractual right to register a share transfer is independent of the shareholder's contractual obligations. In *The Metzler Group, Inc. v. Kearns*, No. 99 C 1543 (N.D. Ill. Sept. 15 and 24, 1999), the plaintiffs, a publicly-traded issuer and its recently-acquired subsidiary, sued the individuals who had sold the subsidiary to the issuer. (The author and Novack and Macey LLP represented a defendant in the *The Metzler Group* case.)

The issuer alleged that the sellers engaged in fraud in the inducement and that, after the merger, certain sellers breached the merger agreement and their fiduciary duties as officers of the subsidiary. The plaintiff companies did not request to rescind the merger agreement and instead sought money damages.

One of the sellers brought a counterclaim alleging that the issuer had breached a contractual obligation to lift the restrictive legend on her stock. Under the merger agreement, a condition to this contractual right was that the shareholder have tendered an opinion letter satisfactory to the issuer stating that the proposed share transfer was exempt from public registration under the securities laws. The counterclaimant had submitted an attorney opinion letter, but the issuer still refused to allow the sale. Among the issuer's numerous objections to registering the share transfer were that: (a) the opinion letter was not "satisfactory to the Company"; (b) the counterclaimant could not enforce the merger agreement because she had breached it; and (c) the proposed sale might leave the issuer and its subsidiary without recourse against the counterclaimant if they prevailed on their affirmative claims.

The court rejected each of these arguments. First, it dismissed the issuer's objections to the attorney opinion letter as "frivolous." Second, the court held that the general principle that a material contract breach by one party excuses the other party from continuing to perform had no application to plaintiff's share transfer rights. The court reasoned that the issuer's contractual obligation to lift the restrictive legend upon satisfaction of certain conditions was independent of the contractual provisions that the former officer allegedly had breached. Third, the court rejected the issuer's attempt to preserve the former officer's shares to satisfy a potential judgment in the issuer's favor because the issuer had not sought to rescind the merger agreement nor shown any statutory or other ground for holding the stock as security against a future judgment.

Accordingly, on summary judgment, the court ordered the issuer to lift the restrictive legend and register the proposed open-market sales. Impliedly, had the issuer sought to rescind the merger agreement and reacquire the shares, the court would have held that that claim suspended the issuer's contractual duty to perform the requested transfer registration. Absent a claim for rescission, however, the shareholder's alleged breach of a contractual obligation did not suspend the issuer's duty to register the share transfer. To similar effect is the decision in *Diversified Earth Sciences, Inc. v. Hallisey*, No. 73 Civ. 816, 1973 WL 401, at *3-4 (S.D.N.Y. June 12, 1973), which concluded that, "Diversified does not seek rescission in its complaint, only money damages. By implication, therefore, it does not contest the ownership of the shares sought to be transferred. Hence I find that Diversified has no reasonable justification for obstructing the transfer[.]"

A different result from *The Metzler Group* was reached in *Mackinder v. Schawk, Inc.*, No. 00 Civ. 6098 (DAB), 2005 WL 1832385, at *16 (S.D.N.Y. Aug. 2, 2005).

That court, on summary judgment, declined to hold that an issuer's contractual duty to facilitate a transfer registration is severable from the shareholder's contractual obligations. The plaintiff had sold her business to defendant in return for restricted stock. When a dispute arose concerning plaintiff's post-merger performance as an officer of the acquired entity, the issuer refused to lift the restrictive legend from the shares to enable plaintiff to sell them. Plaintiff sued, seeking, among other things, an order requiring defendant to remove the restrictive legend. Although the holding period under Rule 144 had expired, the court denied plaintiff's summary judgment motion on this claim, citing the following language in the restrictive legend:

> The shares represented by this certificate may not be transferred in violation of such act and laws, the rules and regulations thereunder or *the provisions of said stock purchase agreement.... The holder* of this certificate, by the acceptance of this certificate, *agrees to be bound by the provisions of such stock purchase agreement*.

Based on the highlighted language, the court reasoned that:

> It is [] clear from the language contained in the restrictive legend that the shares were *subject to* the Merger Agreement and the Employment Agreement. Defendant Schawk contends that Plaintiff breached these agreements and is thus, not entitled to the lifting of the restrictive legends on the certificates issued to her at the time of the Merger. . . . [T]he issue of whether Plaintiff breached the Employment Agreement remains unresolved at this stage. Since the removal of the restrictive legend turns on this issue, Plaintiff's motion for summary judgment, to remove the restriction on the stock certificates, is DENIED as premature.

The decisions in *The Metzler Group* and *MacKinder* can be reconciled, however. In *The Metzler Group* the restrictive legend stated that the certificate holder agreed to be bound by the merger agreement's restrictions on transfer of the shares. By contrast, in *MacKinder* the restrictive legend stated more broadly that the certificate holder agreed to be bound by "the provisions of the stock purchase agreement" -- not simply by those provisions that govern share transfers. That broader language supported the *MacKinder* court's decision that the issuer had a contractual right to delay the former employee-shareholder's requested share transfer, pending a ruling on whether the shareholder had breached the contract.

Thus, in *The Metzler Group,* as under UCC Section 8-401 and the common law, claims that a former employee had committed fraud and breached contractual and fiduciary duties were held insufficient to bar the employee from selling restricted stock. In *Mackinder*, the court permitted the employer to delay a stock transfer, but it did so where the former employee had agreed in the restrictive legend that any transfer was subject to her compliance with a contract that she was alleged to have breached.

Conclusions

An issuer engaged in a dispute with a recently departed employee should proceed cautiously before trying to gain leverage by refusing the former employee's requests to register transfers of restricted shares or remove restrictive legends. Issuers who want such leverage to be available in future disputes should draft their stock purchase, merger, and employment agreements to provide specifically that the issuer's claims of material breach of contract, fraud, breach of fiduciary duty, or other wrongdoing against the employee entitle the issuer to delay or prevent transfer registration by any holder of the share certificate. Likewise, issuers should draft their restrictive stock legends to specify that the holder agrees to be bound by the associated stock purchase, merger and/or employment agreements as a whole, including, but not limited to, the restrictions on transfer they contain.

Absent such provisions, issuers should presume from the UCC and the decisions discussed above that a court will favor transferability in deciding a former employee's request to sell restricted shares. In that regard, an issuer who wants to delay or prevent a requested share transfer, but lacks an express contractual right to do so, would likely need to rescind the transaction by which the shares were originally obtained to have a secure legal basis for preventing a subsequent stock transfer.

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