

Understanding electronic stock certificates

By Jason Lee

While the first stock issuance is usually an exciting time for a corporation, founders typically relegate to the back burner the decidedly less thrilling task of selecting a form of stock certificate to give investors. Taking a few minutes to understand the basics of stock certificates, however, could point you in the right direction and save your corporation significant re-issuance pain down the road.

At its most basic level, a stock certificate is a document that evidences ownership rights to shares of stock of a corporation. Corporations have three basic options when it comes to stock certificates: (1) issue certificated shares with paper certificates; (2) issue certificated shares with electronic certificates; or (3) forego stock certificates altogether and issue uncertificated shares.

For most companies, moving away from paper certificates can save both time and money. However, there are certain steps a company must take to comport with legal requirements before adopting electronic certificated shares or issuing uncertificated stock. This article explains the basic requirements to keep in mind in choosing the right option for your corporation's stock issuance.

Electronic certificate: a paper certificate in electronic form

When a corporation issues electronic certificated shares, it simply provides stockholders with certificates in an electronic form rather than a paper form. Before issuing electronic certificated shares, a corporation should review its articles of incorporation and bylaws, along with any other agreement with its stockholders to ensure that the corporation is not required contractually to provide paper stock certificates. A proposed form of the electronic certificate should also be presented to the corporation's board of directors for approval before delivery to stockholders.

A stock certificate, whether in paper or electronic form, must generally include on its face certain information, such as (1) the name of the stockholder; (2) the name of the corporation; (3) the number of shares the stock certificate represents; (4) any applicable transfer restrictions; (5) any voting trust arrangement that the shares are subject to; and (6) if the corporation is authorized to issue more than one class or series of stock, a summary of all powers, preferences, rights, and restrictions applicable to the class or series of shares represented by the certificate. In addition, the certificate must be signed by an authorized officer or director of the corporation. Since the validity of electronic signatures is well established under federal law, all of the above requirements can be implemented digitally on the face of an electronic stock certificate.

Uncertificated stock: doing away with certificates altogether

While some investors may, from time to time, request paper or electronic certificates, the majority of investors accept or even prefer uncertificated shares. Accessibility to equity management software like Carta has also made it easier than ever for corporations to issue and administer uncertificated shares.

When a corporation issues uncertificated shares, it does not deliver any certificate to the stockholder, whether in paper or electronic form. Instead, the corporation simply records issuances and transfers of shares in an electronic stock register. Industry practices dictate, however, that a corporation with uncertificated stock should provide investors with some access to

its ledger to monitor equity positions. While a corporation could maintain its stock ledger manually using a simple shared spreadsheet, corporations with a large number of stockholders or a complex equity structure would likely need a more robust equity management software solution to adequately meet its needs.

In Delaware, where the majority of Fortune 500 companies are incorporated, the issuance of uncertificated shares is expressly authorized by law. Prior to issuing electronic stock certificates, however, a corporation should review its articles of incorporation and bylaws, along with any other agreement with its stockholders to ensure that the corporation is not specifically prohibiting the issuance of uncertificated shares. A simple amendment of the bylaws to remove such restrictions may be needed, along with approval by the corporation's board of directors, before uncertificated shares may be issued.

Dealing with legacy paper certificates

Legacy paper certificates is an issue that often comes up when an existing corporation considers switching from paper certificates to electronic certificates or uncertificated shares. A corporation must notify all of its stockholders and offer the opportunity to exchange previously issued paper certificates.

However, a corporation with a large number of stockholders may find the process of recalling and replacing legacy paper certificates to be lengthy and expensive. In such cases, a corporation could still move forward with a partial transition, in which it re-issues some shares as electronic certificated shares or uncertificated shares while allowing holders of the remaining shares to surrender paper certificates on their own timeline. Corporations have significant flexibility to maintain some or all shares of some classes or all classes of stock as either certificated shares or uncertificated shares, so long as holders of paper certificates, holders of electronic certificates, and holders of uncertificated shares of the same class of stock are treated identically. A corporation considering a partial transition should consider using Carta or a similar hybrid equity management platform that can support both certificated and uncertificated stock.

While this article provides a basic summary of electronic stock certificates, keep in mind that stock certificates are governed by state law, and additional requirements could apply to the issuance of electronic stock certificates in your state. If your corporation is issuing stock for the first time or considering switching from paper to electronic stock certificate, you should consult with legal counsel to ensure that the corporation's stock certificates comply with all appropriate state law and regulation.

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