

Delaware Law on Blockchain and Other Automated Stock Transfer and Records Systems

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Delaware requires corporations to be able to produce a list of stockholders entitled to vote and, in some circumstances, to share that list with the stockholders of the corporation.

Corporations are also required to keep a ledger of stock transfers.

For many businesses, this is a fairly simple task because their stockholders rarely change.

If your stockholder base is more active, however, automating the stock transfer record keeping process through blockchain software may be useful to you. In fact, one of the best applications for blockchain technology is automating the tedious process of maintaining stock ownership records. Several states have already changed their corporate statutes to permit the use of blockchain and other technology to record corporate records, including stock ownership ledgers.

Growth in Private Companies with Changing Stock Ownership Creates Demand for a Better System

Obviously, publicly-traded corporations have a rapidly changing stock ownership base, but some types of private corporations do as well. There are many reasons that private companies now may have large numbers of changing owners (and that many more are likely to in the future) including:

- COINS and Tokens offerings (some of which may be equity securities) are being marketed to retail investors in the United States and foreign jurisdictions. In many cases, these investors are reselling without restrictions.
- Several years ago, the number of record owners triggering the application of public company reporting requirements under Section 12 (g) of the Securities Exchange Act of 1934 was increased to 2,000 as long as the number of Accredited Investors in that company did not exceed 500. This encouraged some private companies to increase their number of shareholders.
- The emergence of crowdfunding has increased the number of private businesses that have hundreds of stockholders. Certain crowdfunding exemptions (Regulation CF and Tier 2 of Regulation A) provide that owners who purchase shares in applicable offerings are not counted toward the number of stockholders that trigger Section 12 (g) registration, which would require the filing of reports as a public company.
- Regulation A permits stockholders to resell their shares in the same offering the issuer uses to raise capital. This facilitates a few large stockholders reselling to many other investors while the company is still private, creating an overall increase in shareholders.
- Early angel investors are becoming more proactive in seeking to exit their investments before the corporation is sold or

becomes public, allowing these companies to stay private longer.

- Brokers-dealers are operating secondary trading markets for mature private companies.
- Corporations are choosing to stay private much longer than several decades ago, including "Private Unicorns" with market caps that exceed \$1 billion.
- Public reporting requirements under Sarbanes-Oxley and other "reforms" make it more expensive to be a public company, which has caused many businesses to choose to stay private, resulting in a substantial decrease in the number of public companies.
- Large private tech and science-based businesses have granted stock options and restricted stock to many employees.
- Private equity funds provide the capital for private businesses to grow much larger without becoming public. In addition, many of these businesses reward employees with equity grants.
- Families use trusts and LLCs for estate tax planning purposes and shares may be distributed to many family members.

All of these factors are increasing the demand for cheaper, more efficient, stock transfer systems.

2017 Changes to Delaware Law Regarding Blockchain and Other Record Keeping Technologies

The Delaware General Corporation Law ("Delaware GCL") was amended in 2017 to authorize using "electronic networks and databases" for the records that state law requires corporations to maintain.

Section 224 of the Delaware GCL says that corporate records may be kept on "one or more electronic networks or databases (including one or more distributed electronic networks or databases)." This authorization is broader than either stock transfer records or blockchain. It applies to any type of corporate records and to any type of "electronic records of databases."

Section 219 of the Delaware GCL specifically covers stockholder lists. Section 219 (c) defines what a stock ledger is, but Section 219 does not use the term "stock ledger" other than in the definition.

(c) For purposes of this chapter, "stock ledger" means 1 or more records administered by or on behalf of the corporation in which the names of all of the corporation's stockholders of record, the address and number of shares registered in the name of each such stockholder, and all issuances and transfers of stock of the corporation are recorded in accordance with § 224 of this title. The stock ledger shall be the only evidence as to who are the stockholders entitled by this section to examine the list required by this section or to vote in person or by proxy at any meeting of stockholders.

The Delaware GCL requires four types of information to be in a stock ledger:

- Stockholder name;
- Stockholder address;
- Number of shares registered under each name; and,
- All issuances and transfers.

So, What Does a Corporation Do if a Record Owner Provides Only a Blockchain Address?

No law requires any person to have a physical mailing address to qualify to own stock. The drawback is, however, that because no law requires a shareholder to inform corporations in which they own stock of an address change, many stockholders are unreachable. Nonetheless, shareholders can choose to provide a corporation with their electronic or other addresses.

What Other Information Does the Delaware GCL Require to be Included in the Corporate Records?

Tax and other laws may require businesses to report information to the IRS and other agencies, including names associated with social security and other tax ID numbers for reporting tax information. However, the Delaware GCL does not require such tax ID information to be in the stock ledger. Although the Delaware GCL doesn't require some stockholder information, securities laws (such as those relating to bad actors, accredited investors, and beneficial ownership) may influence decisions

about what information corporations should require stockholders to provide.

Note that the requirements for a *stockholder ledger* are different from a *stockholder list*—the stockholder list is not required to include all issuances and transfers, while the ledger is, and the stockholder list need not contain email addresses.

Section 219 (a) of the Delaware GCL provides that:

The corporation shall prepare, at least 10 days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting; provided, however, if the record date for determining the stockholders entitled to vote is less than 10 days before the meeting date, the list shall reflect the stockholders entitled to vote as of the tenth day before the meeting date, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder. Nothing contained in this section shall require the corporation to include electronic mail addresses or other electronic contact information on such list.

Stock ledgers are part of the “books and records” of a corporation. Section 220 of the Delaware GCL gives stockholders limited rights to inspect corporate books and records and specifically includes “the corporation’s stock ledger, a list of stockholders and other books and records.”

Maintenance Requirements of Electronic Records

Section 224 of the Delaware GCL governs the form of corporate record. It does not require corporations to maintain paper records, but it does require that records kept in electronic form be kept so that they “can be converted into clearly legible paper form within a reasonable time.”

More specifically, Section 224 of the Delaware GCL provides that records kept in electronic form must be kept so that they:

[C]an be used to prepare the list of stockholders specified in §§ 219 and 220 of this title, (ii) record the information specified in §§ 156, governing partly paid shares], 159 [transfer rules for shares transferred as collateral security], 217(a) and 218 of this title, and (iii) record transfers of stock as governed by Article 8 of subtitle I of Title 6 [governing security interests in stock and other financial assets].

Other provisions of the Delaware GCL permitting notices to be delivered in electronic form enable corporations to communicate with their stockholders through blockchain addresses. These include:

- Notices of preferences and special rights for stock certificates ;
- Stock transfer restriction notices;
- Electronic notices and,
- Notices regarding “public benefit” status.
- The bottom line is that blockchain stock transfer records can, if thoughtfully implemented, satisfy the requirements of the Delaware GCL.

The Use of Blockchain in Practice.

Blockchain is a relatively new technology. Corporations may find that they need to customize blockchain software to make it suitable for stock transfer ledger purposes. For example, corporations may want to make it easier to locate and convert into paper form the information required to satisfy the paper and inspection requirements of Delaware GCL.

This raises the question of what type of blockchain should corporations use for stock transfer ledger purposes. While other blockchain solutions may emerge over time, currently the Ethereum Network is a good candidate because it accommodates “Smart Contracts” that permit corporations to decide what data to collect and who has access to the information.

Of course, there are several important differences between using traditional stock transfer records and blockchain because

blockchain:

- Enables sellers to make it known that they want to sell, how many shares they want to sell, and the price at which they are willing to sell;
- Enables buyers to make it known that they want to buy, the number of shares they want to buy, and the price they want to pay;
- Facilitates direct communications between potential sellers and buyers; and,
- Actually powers the transaction between buyers and sellers instead of passively recording it after the fact.

All of these blockchain capabilities raise securities law issues for corporations intending to use it for their stock transfer ledgers, including compliance with:

- Offering rules for original issuances by issuers;
- Stock transfer restrictions following issuances of unregistered securities;
- Section 12 (g) of the Securities Exchange Act of 1934;
- Broker-dealer issues; and,
- Rules related to securities trading exchanges.

Unless corporations understand rules for stock transfers and include in their software functions that assure compliance, they risk violating numerous securities laws. Smart Contracts are vehicles for establishing these rules.

We will deal with these issues in future articles.

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