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Why A Privately-Held Company May Have To Disclose That It Might Be Sold

Gray Reed & McGraw Legal Alert

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The Case: Finnerty v. Stiefel Laboratories, Inc., No. 12-13947 (11th Cir. June 30, 2014)

The Eleventh Circuit Court of Appeals has upheld the trial court's ruling that a former employee who owned vested employee stock bonus plan ("ESBP") shares was entitled to a $1.5 million damage award against Stiefel Laboratories, Inc., a privately-held Company.

Background

Privately-held companies do not like to disclose discussions about possible mergers/acquisitions/sales because, among other things, such disclosures have the potential to damage relationships with suitors, customers, vendors, and employees. Indeed, one reason that privately-held companies eschew going public is that they do not want to assume a public company's affirmative duty to disclose certain matters.

So, how did this privately-held company find itself with duty to disclose its pending merger discussions to a former employee who was a participant in the ESBP?

The Court found that the Company had made its family-owned, privately-held status an important part of its identity.

The Court also noted that following a significant investment in the Company by The Blackstone Group, the Company issued a press release stating that the Company "will continue to be privately-held, and the Stiefel family will retain control and continue to hold a majority share ownership of the company." An email to the same effect was sent to Company employees.

Timeline

- August 29, 2008 - Finnerty was terminated as a sales representative of the Company. Upon termination of employment, Finnerty became entitled to a distribution of the vested benefits in his ESBP account in the form of Company stock. Finnerty also received under the ESBP a “put option” with respect to the distributed Company shares, which allowed him to require that the Company buy back such shares at a fair market value during a certain window of time.

- November, 2008 – Unknown to Finnerty, the Stiefel family began exploring the possibility of selling the Company.
- December 30, 2008 – The Company hired Blackstone Advisory Services to advise on a potential sale.
- January 6, 2009 – Without knowledge of the Company’s retention of an investment banker and its discussions with the unsuccessful suitor, Finnerty irrevocably elected to “put” his shares to the Company at the then effective fair market value of $16,469.00 per share.
- January, 2009 – The Company executed a confidentiality agreement with the unsuccessful suitor and contacted other possible suitors, including GlaxoSmithKline (“GSK”). Thereafter, the unsuccessful suitor and GSK submitted non-binding bids.
- February 13, 2009 – The Company consummated the purchase of Finnerty’s ESBP shares.
- April 20, 2009 – The Company and GSK entered into a purchase agreement providing that holders of Company stock would receive $68,515.29 per share, with the possibility of an additional $7,186.00 per share if certain performance conditions were met.
- Finnerty sued the Company asserting, among other things, a violation of Rule 10b-5 under the Securities Exchange Act of 1934 on the theory that the Company had a duty to disclose to Finnerty information relating to its merger negotiations with the unsuccessful suitor, and failed to do so. The jury returned a verdict in favor of Finnerty and awarded him compensatory damages of approximately $1.5 million.

The Eleventh Circuit Court of Appeals Opinion

On appeal, the threshold issue for the Eleventh Circuit Court was whether the Company had a duty to disclose to Finnerty anything about the sales process prior to his irrevocable “put” election.

The Court explained that while there is no obligation to update any prior statements about a historical fact, there is a duty to update forward-looking statements, which are statements that contain “an implicit factual representation that remain[s] ‘alive’ in the minds of investors as a continuing representation.”

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The Court stated that whether there is a duty to revise or update a past disclosure is normally an issue for the finder of fact, and the context is significant.

The Court held that the evidence in the record was sufficient to support the jury verdict in favor of Finnerty on the duty to disclose issue. The Court reasoned that the jury could have reasonably concluded that Finnerty attached a special significance to statements that "the Company will be privately-held" particularly because such statements were reinforced by the Company's history and long-standing philosophy. Finnerty testified that the Company's privately-held status was "brought up" in virtually every meeting.

Moreover, the Court held that there was sufficient evidence for the jury to find that the Company considered itself to be a serious acquisition target prior to Finnerty's "put" election. The Court concluded that "Retaining an investment bank after corporate executives had met and begun to negotiate, 'arguably demonstrate[s]' that a company's intention to merge has moved beyond its incipient stages and ripened into purposeful action…."

The jury could have found that nondisclosure of [the Company's] interests in a merger with [the initial suitor] misled...[Finnerty] into believing that the company remained unavailable for acquisition, when in fact, it was engaged in serious talks with a potential acquirer." In other words, the jury could have reasonably concluded that such nondisclosure rendered the Company's "will continue to be privately-held" statements misleading or deceptive to…[Finnerty]…thus giving rise to the duty to update."

The Court noted that the Company did not need to go into detail about the status of its merger negotiations with the unsuccessful suitor. It could merely have said (communicated to Finnerty) that a sale of the company was under active consideration before it repurchased shares from him. The Company then argued that there was not sufficient evidence for the jury verdict that the talks with the unsuccessful suitor were material as required by Rule 10b-5. The Court, citing Basic v. Levinson, 485 U.S. 224 (1988), stated that the test of materiality with respect to merger negotiations "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."

The Court concluded that the Company's discussions with the unsuccessful suitor were sufficiently advanced by January 6, 2009, the date on which Finnerty exercised his "put" option, for the jury to find them material. The Court pointed to three factors in this respect:

1. The CEO of the Company had met with the CEO of the unsuccessful suitor to discuss the strategic fit between the two companies.

2. The Company had retained an investment banker to facilitate the sale.

3. Such investment banker had conducted a valuation analysis that had shown that the potential acquisition price could be very substantial.

The Takeaway

First, this case is a reminder that even privately-held companies with minority shareholders, including participants in equity-based employee benefit plans and holders of outstanding options, are subject to the disclosure obligations of the federal securities laws, including Rule 10b-5.

Second, as the Court pointed out, the disclosure duty and material issues are generally matters of fact for the jury, and therefore, the importance of this case in the private company context may be somewhat limited because of the unusual facts of this particular case. This case may be an example of “bad facts make bad law.” In this case, there were numerous consistent, unqualified statements over a long period of time that the Company’s founders were going to keep the Company privately-held, which, according to the Court, supported the jury’s finding that the Company had a duty to disclose to plan participants that it was actively considering a sale, even at a very early stage in the sales process.

Third, the lesson for privately-held companies with minority shareholders, including participants in equity-based employee benefit plans and holders of outstanding options, is this: be sensitive to the securities law implications about statements to your shareholders and employees, about exit strategy plans (or the lack thereof) well before going public or undertaking a sale.

Fourth, this case may be somewhat alarming to public companies (who might be exploring a sale) and their insiders as the Court found that the sales process was sufficiently advanced to be material even at an early stage in the process.

Fifth, for counsel representing a company in connection with its sale, particularly special mergers & acquisitions counsel retained for the sale, ask about: (i) prior statements relating to the possible sale of the company and review such statements, and (ii) any recent pending or future transactions by the company, its insiders, and/or minority shareholders in company stock, including possible “put” exercises under equity-based employee benefit plans and stock transfers incidental to divorce proceedings and/or settlements.

Sixth, the ESBP was regulated by the Employee Retirement Income Security Act (“ERISA”). A discussion of ERISA is beyond the scope of this Client Alert as the ERISA considerations, while discussed at length in the Eleventh Circuit opinion, did not materially affect the outcome. However, this case suggests that corporate counsel to a company with an ERISA-regulated, equity-based employee benefit plan should be discussing with the company’s ERISA counsel: whether (and, if so, how) “black-out” periods (which are used in insider trading polices adopted by publicly held companies) can be used to suspend for securities law reasons (i) the plan's obligation to distribute vested benefits to participants and/or (ii) the participants' "put" options and/or the company's obligation to honor such "put" elections.

If you have questions regarding company disclosure with respect to the sales process or other corporate or securities issues relating to your business, we invite you to contact your attorney or the Securities Law Section of Gray Reed & McGraw at 214-954-4135.

For a PDF version of the alert, click here.