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SECURITIES LAW

Potential Mergers Come With Disclosure Obligations

Commentary by Victor DiGioia

A recent decision from the U.S. Court of Appeals for the Eleventh Circuit case in *Finnerty v. Stiefel Laboratories*


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may have changed the disclosure landscape for privately held companies—and not necessarily for the better.

Stiefel Laboratories Inc. was a family-owned, privately held company for over 160 years. Coral Gables-Based Stiefel took great pride in its ownership, bringing it up at nearly every meeting, and impressing upon its employees that it was committed to keeping the company under the Stiefel family's control. In 2007, when the Blackstone Group obtained a minority stake in the company, Stiefel issued a news release, going out of its way to reassure its employees that Stiefel would remain privately held and under the control of the Stiefel family.

Finnerty worked as a sales representative for Stiefel from 1986 until his termination in 2008. As an employee, he participated in Stiefel's Employee Stock Bonus Plan. When he was terminated, he became entitled to a distribution of the vested benefit in his ESBP account, paid in the form of Stiefel stock. He also received a "put" option on the distributed stock. This option allowed him to sell his stock back to Stiefel at fair market value during a certain period of time.

A few months after his termination, Finnerty exercised this option, selling his stock back to Stiefel at the then-fair market value of $16,469 per share. What Finnerty didn't know was that at the same time he was exercising his put option, the Stiefel family was engaged in preliminary merger negotiations with a few different potential suitors, particularly Sanofi-Aventis.

The transaction was never consummated; however, three months after Finnerty exercised his put option, Stiefel agreed to a merger with GlaxoSmithKline. In the GSK deal, Stiefel stockholders received approximately $68,515.29 per share, with the possibility of another $7,186.91 per share if certain performance conditions were met. This was four times the value Finnerty received for his shares when he exercised his put option.

ERISA, SECURITIES CLAIMS

Finnerty filed suit against Stiefel in the Southern District of Florida, alleging violations of ERISA as well as Section 10(b) of the Securities Exchange Act of 1934 and accompanying Rule 10b-5. Most important, Finnerty alleged that Stiefel withheld material information about its preliminary merger negotiations with Sanofi-Aventis that it had a duty to disclose. The district court found for Finnerty, awarding him $1.5 million in compensatory damages. Stiefel appealed to the Eleventh Circuit. The Eleventh Circuit affirmed the district court's ruling in favor of Finnerty.

Specifically, the Eleventh Circuit held that Stiefel had a duty to disclose facts that were necessary to make its statements that it would "continue to be privately held" not misleading.

In other words, the court held that Stiefel's discussions with Sanofi-Aventis were sufficiently advanced at the time Finnerty exercised his put option for them to be "material" under the securities laws. Stiefel had a duty to update Finnerty and inform him that a sale of the company was under serious and active consideration before it repurchased its stock from him.

According to the Eleventh Circuit, Stiefel did not have an obligation to disclose the existence or status of its merger negotiations with Sanofi-Aventis in particular, but it should have said that the company was considering a possible sale.

Notably, the Eleventh Circuit did not decide whether Stiefel had an immediate duty to update employees when the negotiations with Sanofi-Aventis became serious.

Employee stock options are a time-honored benefit. but a company considering an option plan must realize that options are securities and issuing options to employees is similar in many respects to the sale of common stock to outside investors.

Employee-option holders are entitled to the same information and protections when making an "investment decision" whether or not to exercise an option as any other investor. Most companies selling securities to raise capital would not hesitate to seek the advice of a securities attorney. A company considering an option plan would be well-advised to act similarly.

Victor DiGioia is the managing shareholder of Becker & Poliakoff's New York office where he leads the firm's corporate and securities practice.