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Securities Regulation: Rule 10b-5 and the Duty to Disclose Material Information "In Connection With" Stock Repurchase Agreements (Smith v. Duff & Philps, Inc., 891 F.2d 1567 (11th Cir. 1990))

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CASE COMMENTS

SECURITIES REGULATION: RULE 10b-5 AND THE DUTY TO DISCLOSE MATERIAL INFORMATION "IN CONNECTION WITH" STOCK REPURCHASE AGREEMENTS

Smith v. Duff & Phelps, Inc., 891 F.2d 1567 (11th Cir. 1990).

Appellee (Smith), an employee-shareholder[1] of the appellant,[2] a closely-held[3] corporation (Phelps), filed suit alleging[4] that Phelps violated Rule 10b-5[5] of the Securities Exchange Act of 1934. Smith alleged that Phelps failed to disclose material information affecting the value of Smith's stock in Phelps before repurchasing the stock pursuant to a mandatory stock repurchase agreement.[6] Upon Smith's retirement,

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**Editor's Note:* This comment received the *Huber Hurst Award* for the outstanding case comment submitted in the Spring 1990 semester.

1. Smith v. Duff & Phelps, 891 F.2d 1567 (11th Cir. 1990). The original plaintiff died shortly after this action. His widow, as executrix of his estate, was substituted as plaintiff. *Id.* at 1568 n.1.

2. *Id.* at 1568-69. Plaintiff-Appellee sued both Duff & Phelps, Inc. and its president and largest shareholder. *Id.* This comment refers only to Duff & Phelps, Inc. as appellant.

3. *See generally* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS, § 1.07, at 24 (3rd ed. 1987) [hereinafter O'NEAL] (characteristics of typical close corporations include: small number of shareholders; no ready market for the stock; and extensive participation in management by most or all shareholders).

4. *Smith*, 891 F.2d at 1569. The original complaint included claims under the Racketeer Influenced and Corrupt Organizations Act and under Alabama state law. *Id.*

5. 17 C.F.R. § 240.10b-5 (1989). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person,
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> in connection with the purchase or sale of any security.

Id.

6. *Smith*, 891 F.2d at 1568. The stock repurchase agreement provided in relevant part: "upon the termination of the employment with the corporation for any reason, including resignation, discharge, disability or retirement, the individual whose em-

Phelps repurchased Smith's stock for its adjusted book value[7] without disclosing information regarding Phelps' ongoing merger negotiations.[8] Phelps moved for summary judgment, contending that it had no duty to disclose the merger negotiations in connection with the purchase of Smith's stock because Smith was under a contractual obligation to sell back his shares upon termination of his employment.[9] After denying Phelps' motion for summary judgment, the district court certified an interlocutory appeal[10] to resolve the duty of disclosure issue.[11] On certification, the Eleventh Circuit HELD, Phelps had a duty to disclose any material facts to Smith which Phelps would have had to disclose to any shareholder before repurchasing shares in the absence of a stock repurchase agreement.[12]

In the early 1900s, the prevailing common law held that an insider's fiduciary duty ran only to the corporate entity, not to its shareholders.[13] As a result, officers, directors, and majority shareholders could

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> ployment is terminated . . . shall sell to the Corporation and the Corporation shall buy all shares of the Corporation then owned by such individual. . . . The price to be paid for such shares shall be equal to the adjusted book value (as hereinabove defined) of the shares on the December 31 which coincides with or immediately precedes the date of such individual's employment."

Id.

7. *Id.* at 1568. Appellant paid $100 for each of the appellee's 400 shares. *Id. See generally* O'NEAL, *supra* note 3, § 7.30, 142 n.1 (describing the book value of a share, if there is only one class of stock outstanding, as the corporation's net worth divided by the number of shares outstanding).

8. *Smith*, 891 F.2d at 1568. Appellant had been engaged in merger negotiations with a prospective purchaser for over a year before purchasing appellee's shares. *Id.* One year later, appellant reached an agreement to sell all of its stock for between $1,700 and $2,000 per share. *Id.*

9. *Id.* at 1569. Appellant made two motions for summary judgment. The motion not at issue here involved the statute of limitations.

10. *See* 28 U.S.C. § 1292(b) (1989) (giving district judge authority to certify to the Court of Appeals controlling questions of law as to which there is substantial ground for difference of opinion).

11. *Smith*, 891 F.2d at 1569. The Eleventh Circuit considered the issue of

> "whether a corporation has a duty under the federal securities laws to disclose to a stockholder-employee facts which might indicate that the stock is worth more than the contractually determined book value when a stockholder-employee has a contractual duty to sell his stock back to the corporation at the termination of his employment for that book value."

Id. A second issue addressed whether the statute of limitations period for Rule 10b-5 is determined by state or federal law. *Id.*

12. *Id.* at 1575.

13. Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933) (position as director creates no fiduciary duty to the individual stockholders unless director personally seeks out stockholders for the purpose of buying their shares).

purchase stock from outsiders without disclosing secret information regarding the true value of the stock.[14] However, an important exception to the majority rule developed which forced insiders to disclose "special facts"[15] that were certain to significantly affect the stock's value.[16] The stricter minority common law rule[17] imposed a duty of full disclosure on officers and directors, at least in face-to-face transactions.[18]

Following the Securities Exchange Act of 1934 ("1934 Act"), federal law began to dominate insider trading regulation and overshadow common law rules.[19] The stated purposes of the 1934 Act were to prevent fraudulent practices and to promote the disclosure of information in the securities market.[20] Under Section 10(b),[21] the Securities Exchange Commission ("SEC") enacted Rule 10b-5,[22] making it unlawful for any person to misstate or omit[23] a material fact[24] in connection with the

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14. *See* O'NEAL *supra* note 3, § 8.12, at 127.

15. *See id.* (listing a contract by outsiders to buy corporate assets at a high price as an example of special facts).

16. Strong v. Repide, 213 U.S. 419 (1909).

17. WILLIAM L. CAREY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 724 (6th ed. 1988) [hereinafter CAREY] (minority rule was also known as the Kansas rule).

18. Hotchkiss v. Fischer, 16 P.2d 531 (Kan. 1932).

19. *See* CARY, *supra* note 17, at 726.

20. *See* Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir. 1970) (1934 Act "designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete and misleading information"). *Id.*

21. 15 U.S.C. § 78j(b) (1982). Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

22. *See supra* note 5 for the text of Rule 10b-5.

23. Courts require scienter for liability under Rule 10b-5. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (private actions will not lie without an "intent to deceive, manipulate, or defraud").

24. The omitted or misrepresented fact must be considered material. *See* TSC Industries v. Northway, 426 U.S. 438, 449 (1976) (standard of materiality is satisfied by "a showing that . . . the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder"). *Id.*

purchase or sale[25] of any[26] security.[27] Although the SEC did not explicitly provide for private civil actions founded upon violations of Rule 10b-5,[28] the courts[29] have consistently allowed such actions.[30] Yet, the boom of civil litigation under Rule 10b-5 did not occur until after the landmark case of *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*[31]

In *Texas Gulf Sulphur*, corporate employees traded shares in the corporation's stock based on inside knowledge of an important mineral discovery.[32] After the discovery, the corporation's president instructed the employees to keep the information confidential to facilitate acquisition of the surrounding land.[33] Several employees involved in the discovery purchased and sold substantial amounts of stock in the corporation before news of the discovery became public.[34] The *Texas Gulf Sulphur* court found that the employees violated Rule 10b-5, and held that anyone possessing material inside information must either disclose the information or abstain from trading in the security until the information becomes public.[35]

Although *Texas Gulf Sulphur* was not a private action for damages, the language of the opinion fueled a plethora of civil litigation under Rule 10b-5. *Toledo Trust Co. v. Nye*,[36] for example, examined a corporation's duty to disclose material facts to a shareholder's estate before exercising a repurchase option.[37] In *Nye*, the corporate by-laws gave the corporation the option to repurchase stock for its fair market value upon the death of a shareholder.[38] Following a shareholder's death, the corporation repurchased decedent's stock according to the terms of the repurchase option.[39] Subsequently, the corporation sold

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25. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that one claiming damages under Rule 10b-5 must have purchased or sold the securities).

26. Section 10(b) applies to any security whether registered on a national security exchange or not. *See supra* note 21 for the text of Section 10(b).

27. *See generally* O'NEAL, *supra* note 3, § 8.13, at 135-36.

28. *See generally id.* at 136.

29. Kardon v. National Gypsum, 69 F. Supp. 512 (E.D. Pa. 1946).

30. *See* O'NEAL, *supra* note 3, § 8.13, at 136.

31. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

32. *Id.* at 843-44.

33. *Id.* at 843.

34. *Id.* at 844.

35. *Id.* at 848.

36. 588 F.2d 202 (6th Cir. 1978).

37. *Id.*

38. *Id.* at 203.

39. *Id.* at 204-05.

all its stock at a much higher price per share pursuant to a merger.[40] Plaintiff, the decedent's estate, sued the defendant corporation under Rule 10b-5, alleging that defendant coerced plaintiff into selling the shares back to defendant before the merger for less than full value.[41] The Sixth Circuit rejected plaintiff's claim and held that defendant had no duty to disclose the potential merger since plaintiff had no control over the event which triggered defendant's repurchase option — namely, the decedent's death.[42]

In *Jordan v. Duff & Phelps, Inc.*,[43] the Seventh Circuit resolved a similar issue involving a corporation's duty to disclose material information before buying back its stock under a repurchase agreement.[44] In *Jordan*, the plaintiff was an employee-shareholder of the defendant corporation.[45] Upon plaintiff's retirement, defendant repurchased plaintiff's stock for the adjusted book value in compliance with the terms of the repurchase agreement.[46] Soon after, plaintiff learned of defendant's pending merger[47] with a publicly-held corporation, a fact which, if known by plaintiff, would have increased the value of plaintiff's shares to almost thirty times what defendant paid to repurchase them.[48]

The *Jordan* court held that defendant had a duty to disclose material facts affecting the value of the shares since the decision to resign was within plaintiff's control.[49] The *Jordan* court distinguished the voluntary nature of resignation from the involuntary nature of death or termination for good cause, on the basis of the employee's control over the date of termination.[50] Therefore, in *Jordan*, the choice of when to retire was considered an investment decision since plaintiff had the freedom to leave on a date when the value of his stock was the highest.[51]

In the instant case, the court followed the rationale in *Jordan* and held that the stock repurchase imposed upon Phelps the same duty

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40. *Id.* at 205. The price per share defendant received under the takeover agreement was roughly thirty times the price per share plaintiff received for the stock a few months earlier. *Id.*
41. *Id.*
42. *Id.*
43. 815 F.2d 429 (7th Cir. 1987).
44. *Id.*
45. *Id.* at 431.
46. *Id.* at 432.
47. *See supra* note 8.
48. *Jordan*, 815 F.2d at 432-33.
49. *Id.* at 437.
50. *Id.*
51. *Id.*

of disclosure that would have existed absent Smith's contractual obligation to sell back the shares.[52] The instant court recognized that a stock's book value changes with market conditions and that an outside corporation acquiring the stock may pay a much higher price per share than would the target company.[53] Thus, the court reasoned that Smith held the same investor status as a public stockholder.[54] The only distinction between Smith and a holder of public stock rested in Smith's obligation to sell back the shares upon termination of his employment.[55]

The instant court found that the critical issue in *Nye*, *Jordan*, and the instant case concerned the shareholder's control over the event triggering the enforcement of the repurchase agreement.[56] The instant court agreed with *Nye*'s holding that no duty of disclosure exists when the shareholder's death triggers the repurchase;[57] however, it distinguished other types of events which terminate the employment relationship.[58] When an employment relationship ends because of death or termination for good cause, the shareholder clearly loses the option to remain an employee.[59] Since the shareholder cannot forestall the sale of stock under these circumstances, disclosure of information is irrelevant.[60] However, when employment is terminated voluntarily by the employee's retirement, as in *Jordan*, or resignation, as in the instant case, the employee-shareholder controls the investment decision of when to sell the shares.[61]

The instant court acknowledged that public disclosure of pre-merger negotiations could spark unwanted competition and speculation that might drive down bids or deter potential bidders from bidding altogether.[62] However, the court concluded that disclosure to an employee of a closely-held corporation would not jeopardize the confiden-

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52. *Smith*, 891 F.2d at 1575.

53. *Id.* at 1574.

54. *Id.* at 1573-74.

55. *Id.* at 1573.

56. *Id.*

57. *Id.*

58. *Id.* at 1574.

59. *Id.*

60. *Id.*

61. *Id.* Phelps urged that Smith possessed no control over the term of his employment since Smith's at-will employment status enabled Phelps to fire him and enforce the repurchase contract at any time. *Id.* The court flatly rejected Phelps' argument, stating that the court would not likely tolerate such an opportunistic abuse of the at-will employment relationship. *Id.*

62. *Id. See generally* C. Daniel Ewell, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 YALE L.J. 547 (1987) (explaining advantages to both the target and acquiring corporations of conducting negotiations in secret and also explaining how shareholders in the aggregate benefit by remaining uninformed during negotiations).

tiality of the information.[63] Thus, the court found that Phelps had no legitimate reason for omitting the material information before buying Smith's shares.[64] In fact, the instant court reasoned that the only real purpose for the omission was to further the financial gain of the majority shareholders at the expense of the minority shareholders.[65]

The instant court limited its decision to resolving the certified issue on appeal.[66] The court assumed for purposes of its decision that the information omitted was material and that Phelps would have had a duty to disclose the information absent the repurchase agreement.[67] The instant court then held that the duty to disclose material information under Rule 10b-5 remained unaltered by the contractual obligation.[68]

The instant court properly recognized that the repurchase of stock by Phelps pursuant to a contractual repurchase agreement fell within the purview of *Texas Gulf Sulphur*.[69] Although the repurchase agreement provided no alternative, Phelps purchased its own shares while in possession of material, non-public information.[70] *Texas Gulf Sulphur* held that full disclosure of all material information must precede any such transaction.[71] Therefore, Phelps' fiduciary duty of disclosure did not vanish simply because Phelps was obligated to repurchase the shares under a mandatory repurchase agreement.[72]

The instant decision reinforced *Jordan* which held that an employee-shareholder is a true investor.[73] Smith, like any other investor, paid for his stock and held it because of its potential to increase in value. As an investor, Smith had the right to sell the stock on a fully informed basis[74] to the extent he controlled the timing of the transaction.[75] Therefore, Smith's voluntary decision to retire was an investment decision completely within his control.[76]

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63. *Smith*, 891 F.2d at 1574.

64. *Id.*

65. *Id.*

66. *Id.* at 1572.

67. *Id.*

68. *Id.* at 1575.

69. *Id.* at 1573-74 (securities laws mandate that an employee-investor choosing to leave the enterprise must be provided any information material to that choice).

70. *Id.* at 1568.

71. *Texas Gulf Sulphur*, 401 F.2d at 848.

72. *See Smith*, 891 F.2d at 1575.

73. *Id.* at 1573-74.

74. *See supra* note 20 and accompanying text.

75. *Smith*, 891 F.2d at 1574. *See* St. Louis Union Trust v. Merrill Lynch, Pierce, Fenner & Smith, 562 F.2d 1040, 1049-50 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978) (no information is material if the individual does not control the decision to sell).

76. *See Smith*, 891 F.2d at 1574.

The instant decision is highly valuable to the extent that it precludes the corporation and its majority shareholders from using stock repurchase agreements to escape their fiduciary duties to minority shareholders. The repurchase agreement in the instant case did not explicitly waive Phelps' duty to disclose material information.[77] The court properly recognized that removing the duty of disclosure based solely on the existence of a repurchase contract would create enormous potential for self-interested dealing by majority shareholders at the expense of the uninformed minority.[78]

However, the instant court went beyond the *Jordan* decision by holding that the disclosure duty under all repurchase agreements, voluntarily triggered by the employee, is identical to the duty under a typical market transaction.[79] Furthermore, the instant court, refused to acknowledge any legitimate interests a corporation might have in withholding disclosure in connection with such mandatory transactions.[80] Thus, the court's decision ignored the legitimate countervailing interests that arise when stock ownership is tied to employment and the corporation is bound to repurchase the employee's shares upon the employee's voluntary resignation.[81] This situation, unlike the typical market transaction, forces the corporation to repurchase shares of its own stock upon the employee's unilateral decision to resign.[82] Therefore, the employee's initiative is sufficient to eliminate one of the two important options available to the corporation under *Texas Gulf Sulphur*.[83] The corporation may no longer sit back and remain silent, no matter how proper its motive, when the corporation is forced to repurchase its own shares.[84]

In many circumstances, the corporation benefits most from withholding information and abstaining from trading in its own stock. Disclosure of sensitive information or secret negotiations, for example, can completely undermine legitimate corporate opportunities.[85] The instant court acknowledged that non-disclosure of premerger negotiations usually yields the greatest benefit to the corporation and the

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77. *See supra* note 6 for the relevant text of the stock repurchase agreement.

78. *See Smith*, 891 F.2d at 1574.

79. *Id.* at 1575.

80. *Id.* at 1574.

81. *See id.* (the court states that the only reason a closely-held corporation would be reluctant to disclose information would be to maximize the profits of the majority shareholders).

82. *See supra* note 6 for the relevant text of the stock repurchase agreement.

83. *See supra* text accompanying note 35.

84. *See supra* text accompanying note 35; *see also supra* note 69.

85. *See e.g., supra* note 62.

aggregate of its stockholders.[86] Yet, the court concluded that non-public information could be disclosed to an employee of a closely-held corporation without jeopardizing the information's confidentiality.[87] In reality, however, even limited disclosure to corporate employees increases the possibility of leaks that could jeopardize the legitimate objectives of the corporation.

Furthermore, mandatory disclosure of material information to employee-shareholders, even if kept in confidence, could result in other hardships to the corporate entity.[88] A good example of such hardship is the burden placed upon the corporate employment structure when employee-shareholders' investment interests begin to completely overshadow their employment interests.[89] In a corporation with a fairly large number of shareholders, many employees, who would otherwise resign, may defer their resignations in hopes of capturing the benefits of some future event.[90] When the anticipated event occurs, or becomes certain not to occur, the company will have to deal with the exodus of many employees whose sole purpose for extending their tenure was to cash in on the anticipated event. Consequently, employee abuse of the unconditional duty of disclosure will force corporations to anticipate and adapt to a highly volatile pattern of employee turnover during periods of expected increases in stock value.

Section 10(b) of the 1934 Act and Rule 10b-5 are directed at preventing manipulative and deceptive conduct in connection with securities transactions.[91] Yet, non-disclosure of material information is arguably not fraudulent if a corporation is forced to repurchase stock at a time when it has compelling reasons for withholding disclosure. Under these circumstances, mandatory repurchase agreements create a unique policy conflict between the legitimate investment interests of the retiring employee and the bona fide business concerns of the corporation and its remaining shareholders. The instant decision unconditionally places the burden of this policy conflict upon the corporation. However, a more appropriate balance might result if courts examine

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86. *See supra* note 62 and accompanying text.

87. *Smith*, 891 F.2d at 1574.

88. *See Jordan*, 815 F.2d 429 (7th Cir. 1987) (acknowledging that a corporation does "not want a viper in its nest, a disgruntled employee remaining only in the hope of appreciation of his stock").

89. *See id.*

90. *See id.*

91. *See* Santa Fe Industries v. Green, 430 U.S. 462, 473-74 (1976) (no Rule 10b-5 cause of action unless "the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute"). *Id.*

the duty to disclose under mandatory repurchase agreements based on factors such as the corporation's size, the number of corporate employees and shareholders, and the amount of stock held by the retiring employee. In addition, some of the burdens which an absolute duty of disclosure imposes upon the corporation in these cases could be alleviated by restricting the standard of materiality[92] to information regarding anticipated events which are fairly certain to occur within a short period of time.[93]

The instant decision thoroughly protects the investment interests of employee-shareholders and deters fraudulent self-dealing by majority shareholders in closely-held corporations.[94] Arguably, the decision overprotects the employee-shareholder to the point of harming the corporation. Focusing almost exclusively on the investment interests of the employee, the instant court overlooked the potential abuses that will likely arise out of an absolute duty to disclose material, non-public information under mandatory stock repurchase agreements. Competing policies will continue to arise which are unique to the marriage of employment and investment. In examining only the employee's interests, the instant decision mandates that courts and corporations ignore the balance of competing policies when determining whether the facts of a given case warrant imposing a duty[95] on the corporation to disclose non-public information to retiring employees.

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92. *Cf.* Ewell, *supra* note 62, at 563-64 (suggesting an extension of the "doctrine of constructive immateriality in cases of corporate silence to cover 'no corporate development' statements"). *Id.*

93. Restricting the materiality standard in this manner would limit the duty to disclose under a mandatory repurchase agreement to situations analagous to the "special facts" situation under common law.

94. *Smith*, 891 F.2d at 1573-75.

95. *See* Kohler v. Kohler, 319 F.2d 634, 638-39 (7th Cir. 1963) (determination of duty "cannot be confined to an abstract rule but must be fashioned case by case as particular facts dictate"). *Id.*