12-13947-DD, 12-15060-DD, 12-15642-DD

UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

TIMOTHY FINNERTY,
Plaintiff-Appellee,

v.

STIEFEL LABORATORIES, INC., AND
CHARLES W. STIEFEL,
Defendants-Appellants.

On Appeal from the United States District Court
for the Southern District of Florida, Miami Division

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION AS *AMICUS CURIAE* IN SUPPORT OF PLAINTIFF-APPELLEE, URGING AFFIRMANCE

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CERTIFICATE OF INTERESTED PERSONS AND CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and the Eleventh Circuit Rule 26.1-1, counsel for the Securities and Exchange Commission, *amicus curiae*, certify that the following additional persons have or may have an interest in the outcome of this appeal:

1. Avery, John W., attorney for the Commission
2. Carlson, James Michael, attorney for the Commission
3. Conley, Michael A., attorney for the Commission
4. Hunt, Patrick M., Magistrate Judge in *SEC v. Stiefel Laboratories Inc., et al.*, No. 11-cv-24438 (S.D. Fl., Miami Division) ("*SEC v. Stiefel*")
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9. Rosenbaum, Robin S., District Court Judge in *SEC v. Stiefel*

CERTIFICATE OF INTERESTED PERSONS

AND CORPORATE DISCLOSURE STATEMENT (CONTINUED)

10. Securities and Exchange Commission
11. Small, Anne K., attorney for the Commission
12. Zloch, William J., District Court Judge in *SEC v. Stiefel*

Dated: June 5, 2013

/s/ David Lisitza

David Lisitza

Securities and Exchange Commission

STATEMENT REGARDING ORAL ARGUMENT

The Securities and Exchange Commission, *amicus curiae*, requests that if the Court orders oral argument the Court also grant the Commission permission to participate in oral argument. See Fed. R. App. P. 29(g). The Commission's participation in oral argument would help the Court address issues presented by this private action under the federal securities laws.

The Commission also seeks permission to participate in oral argument because the Commission has a civil enforcement action pending in the same district court that entered judgment in favor of the plaintiff here, alleging that these same defendants violated in a similar manner the same antifraud provisions at issue in this appeal. See *SEC v. Stiefel Laboratories Inc., et al.*, No. 11-cv-24438 (S.D. Fl., Miami Division).

Should the Court find it necessary, counsel for plaintiff has agreed to cede a portion of its oral argument time to the Commission.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is the agency principally responsible for the enforcement of the federal securities laws, and submits this brief as *amicus curiae* pursuant to Fed. R. App. P. 29(a) to address the proper interpretation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. "[M]eritorious private actions to enforce federal antifraud securities laws are an essential supplement" to civil enforcement actions brought by the Commission. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313, 127 S.Ct. 2499, 2504 (2007).

Furthermore, the Commission has a specific interest in the proper construction of Section 10(b) and Rule 10b-5 in this private action because the Commission has a pending enforcement action in the same district court alleging that these same defendants violated in a similar manner these same antifraud provisions. See *SEC v. Stiefel Laboratories Inc., et al.*, No. 11-cv-24438 (S.D. Fl., Miami Division). Among other things, the Commission's complaint alleges that Stiefel Laboratories, Inc., a privately held corporation, and Charles W. Stiefel, Stiefel Lab's chairman, CEO, and majority shareholder, violated the antifraud provisions by making material misstatements and omissions as part of a scheme to accelerate buybacks of stock under Stiefel Lab's employee stock ownership plan

from its current and former employees ("stockholder-employees") at severely undervalued prices and then sell Stiefel Lab at a substantial premium. See *SEC v. Stiefel* at Dkt. 1. The Commission's action is based on investors who sold their shares from November 2006 to April 2009, while the private action is based on one investor who sold his shares in February 2009.

LEGAL ISSUES ADDRESSED

1. **Deception**: Whether a material misrepresentation would be sufficient to satisfy the deception requirement of Section 10(b) of the Exchange Act, whether or not there is also a breach of a duty to disclose.

2. **Duty**:

(a) Whether there is a duty to correct and update prior statements where the failure to do so would render those statements materially misleading.

(b) Whether a privately held corporation repurchasing its shares from its stockholder-employees on the basis of material, non-public information has a duty to disclose that information or abstain from such repurchases.

3. **Materiality**: Whether the Court can uphold the jury's presumed finding that pre-merger discussions were material under the particular facts of this case without endorsing a bright-line standard under which all pre-merger discussions are material as a matter of law.

SUMMARY OF ARGUMENT

The Commission submits this *amicus* brief to correct erroneous legal propositions that defendants assert regarding three issues.

1. Defendants incorrectly assume that material misrepresentations would be insufficient to establish fraud unless there is also a breach of a duty of disclosure. Misrepresentations satisfy the deception requirement of Section 10(b) whether or not there is also a breach of an independent duty to disclose.

2. Defendants erroneously contend that they owed no duty to refrain from making material omissions under Section 10(b).

(a) Stiefel Lab and Charles Stiefel had a duty to correct and update their prior statements where their failure to do so would render those statements materially misleading.

(b) A privately held corporation such as Stiefel Lab has a duty to disclose or abstain when repurchasing its shares from its stockholder-employees on the basis of material non-public information, and no legal impediment prevented Stiefel Lab's compliance with that duty.

3. Defendants erroneously argue that upholding the jury's implicit finding that certain pre-merger discussions were material would require the Court to endorse an overinclusive, bright-line standard under which *all* pre-merger

discussions are material as a matter of law. Rather, only *material* merger discussions need to be disclosed, and materiality is a fact-specific inquiry that depends on the facts and circumstances in any particular case.

ARGUMENT

I. Misrepresentations are "deceptive" and violate Section 10(b) whether or not there is also a breach of a duty to disclose.

Defendants argue that a "duty to disclose" is an "*essential element*" of an action for securities fraud. Br. 1-2; see also Br. 14-26.[1] This erroneously suggests that misrepresentations are insufficient to establish a violation of Section 10(b) and Rule 10b-5 unless there is also a breach of an independent duty of disclosure, such as a fiduciary or similar duty. Although plaintiff's private cause of action was not tried on the basis of alleged misrepresentations (Pl. Br. 14), it is an important principle of federal securities law that, if a person makes material misrepresentations, the deception requirement of Section 10(b) is satisfied without regard to whether that person has an independent duty to disclose. And as noted, the Commission's enforcement action alleges that Stiefel Lab and Charles Stiefel made material misrepresentations.

Section 10(b) makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security * * * *any* manipulative or

[1] All emphasis is added unless otherwise noted.

deceptive device or contrivance." 15 U.S.C. 78j(b). Rule 10b-5, which was promulgated pursuant to Section 10(b), broadly prohibits "any" artifice to defraud, "any" untrue misstatement or omission, and "any" deceit. 17 C.F.R. 240.10b-5. These antifraud provisions, "by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151, 92 S.Ct. 1456, 1471 (1972). They are read "flexibly" to effectuate their "remedial purposes," namely "to insure honest securities markets and thereby promote investor confidence." *SEC v. Zandford*, 535 U.S. 813, 819, 122 S.Ct. 1899, 1903 (2002).

These antifraud provisions reach both misrepresentations and—where there is a duty—omissions. See *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157, 128 S.Ct. 761, 768 (2008) (Section 10(b) and Rule 10b-5 proscribe "a material misrepresentation *or* omission"). Furthermore, "an affirmative misrepresentation is a distinct species of fraud" that is sufficient to violate Section 10(b) and Rule 10b-5, "[e]ven if a person does *not* have a fiduciary duty to disclose." *SEC v. Dorozhko*, 574 F.3d 42, 49 (2d Cir. 2009). Accord *Semerenko v. Cendant Corp.*, 223 F.3d 165, 187 n.14 (3d Cir. 2000); *Ackerman v. Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991) ("the lack of an independent duty does not excuse a material lie").

II. Both defendants had a duty to correct and update their prior statements where their failure to do so would render those statements materially misleading, and Stiefel Lab had a duty to disclose or abstain when repurchasing shares from its stockholder-employees on the basis of material, non-public information.

In addition to misrepresentations, omissions or silence can also be deceptive under Section 10(b) where the failure to speak breaches a duty to disclose. See *Chiarella v. United States*, 445 U.S. 222, 226-30, 100 S.Ct. 1108, 1113-16 (1980) (discussing duty to disclose arising from "fiduciary or similar relation"). Although defendants argue that they had no such duty, as discussed below, this case implicates two distinct duties of disclosure: (a) Stiefel Lab and Charles Stiefel both had a duty to correct and update their prior statements where their failure to do so would render those statements materially misleading; and (b) Stiefel Lab had a duty to disclose or abstain when purchasing its shares from its stockholder-employees on the basis of material, non-public information.

A. Stiefel Lab and Charles Stiefel had a duty to correct and update their prior statements where their failure to do so would render those statements materially misleading.

"A duty to disclose may also be created by a defendant's previous decision to speak voluntarily. Where a defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive, a duty to disclose arises." *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986), original

emphasis; see also *FindWhat Investor Grp., v. FindWhat.com*, 658 F.3d 1282, 1298-1299, 1305-06 (11th Cir. 2011). Prior statements can implicate both a duty to correct and a duty to update. There is a *duty to correct* prior statements believed to be true when made, if it is revealed that those statements were in fact inaccurate when made and those statements would be materially misleading absent correction. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1430-31 (3d Cir. 1997); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990) (*en banc*). And there is also a *duty to update* statements that were accurate when made, if those statements no longer reflect the true facts and would be materially misleading absent updating. See *Burlington*, 114 F.3d at 1432; *Backman v. Polaroid*, 910 F.2d at 16-17; *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993).

Stiefel Lab and Charles Stiefel had a duty to correct and update their prior statements regarding the value of Stiefel Lab's shares where their failure to do so would render those statements materially misleading. Before the end of each calendar year, Stiefel Lab and Charles Stiefel announced the "current fair market value" of Stiefel Lab shares as of March 31 of that year until April 1 of the next year. Pl. Br. 21 (quoting Stiefel Lab's employee stock ownership plan, PX 56 at 43, included in plaintiff's supplemental record excerpts); see also Pl. Br. 3-4;

Br. 16. That was the price that would be paid to stockholder-employees under Stiefel Lab's employee stock ownership plan. Defendants had a *duty to correct* any valuation that was incorrect when made because, for example, the valuation failed to reflect contemporaneous, material merger negotiations (Pl. Br. 5-9) or other offers to purchase Stiefel Lab's shares at materially higher prices (Pl. Br. 21, 6). See *Burlington*, 114 F.3d at 1430-31.

Even if the valuation was correct when made, defendants also had a *duty to update* their prior statements regarding the valuation, if there was an event after the valuation was announced—and during the year the valuation was in effect—that made that valuation materially inaccurate, such as material merger discussions (Pl. Br. 5-9), or a private equity firm purchasing a significant number of shares at a materially higher price (Pl. Br. 21, 6). Here, defendants' duty to update the valuation is especially clear because they represented that the "fair market value" of Stiefel Lab's shares would be redetermined "from time to time as may be necessary." See PX 56 at 60. Accordingly, the valuation "remained 'alive' in the minds of investors as a continuing representation" that defendants had a duty to update if it became materially inaccurate. *Burlington*, 114 F.3d at 1432.

Stiefel Lab and Charles Stiefel also had a duty to correct and update their prior statements that Stiefel Lab was not for sale but would instead remain a privately held company (Pl. Br. 4-5, 16-18), where their failure to do so would render those statements materially misleading. They had a *duty to correct* their statements that Stiefel Lab was not for sale if they learned that, at the time such statements were made, Stiefel Lab was in fact for sale. See *Burlington*, 114 F.3d at 1430-31. And to the extent their representations that Stiefel Lab was not for sale and would remain a privately held company "remained 'alive' in the minds of investors as a continuing representation" (*id.* at 1432), defendants had a *duty to update* those representations if material merger negotiations with a public company ensued.

B. Stiefel Lab had a duty to disclose or abstain when repurchasing shares from stockholder-employees on the basis of material, non-public information, and there was no legal impediment to its satisfaction of that duty.

Although defendants are correct that a company generally has no affirmative duty under the federal securities laws to disclose any and all material information (Br. 14-15), where a company *trades in its own stock* it does have a duty to

disclose material information or abstain from trading.[2] This duty is especially clear in the context of this case, where a privately held corporation such as Stiefel Lab repurchases its own shares from its stockholder-employees.[3] The duty to disclose or abstain is vital where the corporation's shares are not publicly traded and the corporation exercises control over the market for its shares: it is essentially the only buyer, it establishes the price, and the stockholder-employees must agree to that price in order to sell their shares. This duty to disclose or abstain is not confined to issuers that are close corporations. Nor does this duty depend on state law. Finally, a privately held corporation such as Stiefel Lab is not legally barred from fulfilling its duty to either disclose or abstain.

1. Generally, a corporation is considered an insider with regard to its duty to either disclose or abstain when purchasing its own shares on the basis of material, non-public information.

Just as officers and directors are insiders with an affirmative duty to disclose or abstain when purchasing shares on the basis of material, non-public

[2] A company also has a duty to disclose under certain other circumstances, such as the aforementioned duty to correct and update, or where a company is responsible for leaks into the market (*e.g.*, *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981)), or where regulations promulgated by the Commission require disclosure (*e.g.*, share registration statements under the Securities Act of 1933, proxy solicitations under the Exchange Act).

[3] Plaintiff did not argue that Charles Stiefel violated a duty to disclose or abstain in connection with the purchase or sale of any security. Pl. Br. 25 n.9.

information,[4] it is well established that "the *corporate issuer* in possession of material nonpublic information, must, *like other insiders* in the same situation, disclose that information to its shareholders or refrain from trading with them." *McCormick v. Fund American Co., Inc.*, 26 F.3d 869, 875-76 (9th Cir. 1994), collecting authorities. See also *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1203-1204 (1st Cir. 1996) ("Just as an individual insider with material nonpublic information about pending merger or license negotiations could not purchase his company's securities without making disclosure, the company itself may not engage in such a purchase of its own stock, if it is in possession of such undisclosed information."), citing *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266-68 (1st Cir. 1966); *Levinson v. Basic Inc.*, 786 F.2d 741, 746 (6th Cir. 1986), *vacated on other grounds*, 485 U.S. 224, 108 S. Ct. 978 (1988) ("[c]ourts have held that a duty to disclose [merger] negotiations arises in situations, such as where the corporation is trading in its own stock"); *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963) (the "underlying principles" regarding trading on inside information "apply not only to majority stockholders of corporations and corporate insiders, but equally to corporations themselves").

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[4] See *Chiarella*, 445 U.S. at 227-28, 100 S.Ct. at 1114-15; *SEC v. Adler*, 137 F.3d 1325, 1333-34 (11th Cir. 1998).

The rationale for imposing a duty to disclose or abstain is "the necessity of preventing a corporate insider from . . . taking unfair advantage of the uninformed minority stockholders." *Chiarella*, 445 U.S. at 228-29, 100 S.Ct. at 1114-1115, brackets in original, citation omitted. This rationale applies to corporate officers, directors, and the corporation itself, when they trade in the corporation's securities.

Leading commentators agree that "[t]he term insider traditionally has been held to include * * * issuers when repurchasing their own stock," because "the issuer attempting to repurchase its own shares is the insider par excellence." Loss, Seligman and Paredes, *Securities Regulation*, Chapter 9(B)(5) (May 2013), quotation omitted. See also Donald C. Langevoort, *Who is an insider?—The issuer itself*, 18 Insider Trading Regulation, Enforcement and Prevention § 3:6 (April 2013); Thomas Lee Hazen, *Corporate Affirmative Disclosure Obligations*, 4 Law Sec. Reg. § 12.19[1][B] (Jan. 2013).

Other rules promulgated pursuant to Section 10(b) demonstrate that issuers trading in their own stock have a duty to disclose or abstain. For example, Rule 10b-18 provides an issuer with a "'safe harbor' from liability" under Rule 10b-5 under certain circumstances when the issuer is repurchasing its own stock. 17 C.F.R. 240.10b-18. But, as the Commission has explained, this Rule "confers *no* immunity from possible Rule 10b-5 liability where the issuer engages

in repurchases while in possession of favorable, material non-public information concerning its securities." *Purchases of Certain Equity Securities by the Issuer and Others*, Release No. 33-6434, 1982 WL 33916 at *2, *16 n.5 (Nov. 17, 1982).

Because this duty is implicated only where the defendant corporation trades in its own stock, defendants' reliance (Br. 15, 17-18) on cases where the defendant corporation did not trade in its own stock is misplaced. See *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992) ("There was no suggestion that defendants were trading in Formica stock."); *McCormick*, 26 F.3d at 876-77 & n.4 (distinguishing both *Glazer* and *Taylor v. First Union Corp.*, 857 F.2d 240, 243-44, 246-47 (4th Cir. 1988), on this basis). Defendants mistakenly rely on *Jackvony v. RIHT Fin. Corp.*, 873 F.2d 411, 417 (1st Cir. 1989), which not only rejects defendants' position, but also articulates the Commission's position: a "corporation has no affirmative duty to disclose even material information *if there is no insider trading*, no statute or regulation requiring disclosure, and no inaccurate, incomplete, or misleading prior disclosure." Finally, this Court's decision in *Williams v. Dresser Indus., Inc.* is inapposite because the plaintiffs there did not buy any securities, rather they "bought a distributorship of heavy construction equipment," thus "[f]ederal securities law" was "not controlling." 120 F.3d 1163, 1165-67, 1173 (11th Cir. 1997).

2. In particular, a privately held corporation repurchasing its shares from its stockholder-employees on the basis of material, non-public information has a duty to disclose that information to sellers or abstain from such repurchases.

The duty to disclose or abstain is especially clear where, as here, a privately held corporation repurchases its own, non-publicly traded shares from its stockholder-employees. Indeed, this Court in *Smith v. Duff & Phelps* affirmed a privately held company's liability under Section 10(b) and Rule 10b-5 for intentionally making material omissions about its shares' value when repurchasing shares from a stockholder-employee. See *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990), *rehearing en banc denied*, 904 F.2d 712 (11th Cir. 1990); accord *Jordan v. Duff & Phelps*, 815 F.2d 429 (7th Cir. 1987), *cert. denied*, 485 U.S. 901, 108 S.Ct. 1067 (1988); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 175, 179 (2d Cir. 2001).

In *Smith*, the corporate defendant, Duff & Phelps, was a privately held corporation that repurchased its shares from Smith, a retiring employee, at the book value of $100 per share while failing to disclose material merger negotiations that resulted in a buyout at over $2,000 per share. 891 F.2d at 1568-69. This Court affirmed that Duff & Phelps was liable under the antifraud provisions for this omission because the "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." *Id.* at 1569, 1573-75. Likewise, Stiefel Lab had a duty to disclose to its stockholder-employees, including plaintiff, material facts that indicated its stock was worth more than the share valuation determined under Stiefel Lab's employee stock ownership plan.

In response to *Smith* (Br. 20-26), defendants assert that (i) under *Smith* only "close corporations" have a duty to disclose or abstain; and (ii) Stiefel Lab was not a close corporation because a "close corporation" under the Delaware Code can have no more than 30 shareholders (8 Del.C. 342), while Stiefel Lab had more than 30 shareholders. Neither assertion withstands scrutiny.

First, the duty found in *Smith* does not turn on the corporation's particular *form*. Rather, what this Court found important was the corporation's *control* over the market for its shares. 891 F.2d at 1573 & n.15.[5] This Court explained that a privately held corporation owes a duty to disclose or abstain when purchasing its shares from its stockholder-employees because that kind of market for non-publicly traded shares is "under corporate control." *Id.* This Court noted that in such a case the "corporation is the only potential buyer at the time of

[5] See also *Affiliated Ute*, 406 U.S. at 144-54, 92 S.Ct. at 1467-72 (corporate defendant's control over the market for non-publicly traded shares established the corporation's duty under Section 10(b) and Rule 10b-5 to "disclos[e] to [sellers] material facts that reasonably could have been expected to influence their decision to sell," including "that their shares were selling for a higher price in that market").

termination," and the corporation "has the luxury of establishing the sale value of the stock." *Id.* Stiefel Lab had that sort of market control. Pl. Br. 22 n.6; PX 56. Because in these circumstances stockholder-employees who wish to sell their shares are at the mercy of the corporation to buy them, and to buy them at a fair price, the corporation has an obligation to disclose information that materially affects that price or abstain from purchasing its shares at that unfair price. A corporation's control in this manner over the market for its non-publicly traded shares—irrespective of whether it is privately held or closely held—provides an opportunity for the corporation to abuse its control by profiting at the expense of stockholder-employees they have intentionally left in the dark.[6] This rationale underlies the decision in *Smith*. 891 F.2d at 1574-75 (noting that "opportunism" and "inequitable" results would abound absent the duty to disclose or abstain).[7]

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[6] The privately held and closely held corporation both have an incentive to require stockholder-employees to sell at an artificially low price, and thereby reduce the corporation's cost of acquiring shares.

[7] Section 10(b) and Rule 10b-5 apply to "any person," and the definition of "person" under the Exchange Act encompasses a "company" of any form. Section 3(a)(9), 15 U.S.C. 78c(a)(9). In preventing and remedying fraud through these provisions, it makes no difference whether the corporate defendant that commits fraud is organized as a closely held corporation, privately held corporation, partnership, joint-stock company, etc. See *supra* at 5.

The Second Circuit in *Castellano v. Young & Rubicam* expressly held that the rule that "closed corporations that purchase their own stock have a special obligation to disclose to sellers all material information" applies to a "*privately-held* corporation, owned by a select group of employees." 257 F.3d at 175, 179 ("one of the largest" stockholder-employees owned only "1.2% of all outstanding equity"), citing *Jordan*, 815 F.2d at 434-35 and *McCormick*, 26 F.3d at 876. Where the privately held corporate defendant bought the stockholder-employee's shares at $49, and executed a merger four months later at $115 per share (257 F.3d at 175-76), the court of appeals concluded that the corporation had a duty to disclose material merger negotiations and adjusted valuations (*id.* at 179-186). *Castellano* relied on the corporation's control over the market for its shares: "[t]here was no public market for Y & R's stock," "no shares could be sold or transferred without first offering them to Y & R," and the stockholder-employee "had no power to bargain over the valuation of his shares." *Id.* at 175, 184.

Accordingly, the Commission has concluded that "under Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act, a *privately-held company* may be liable for material misrepresentations or materially misleading omissions when repurchasing securities from its shareholders." *Order Granting an*

Application of BF Enterprises, Inc., Release No. 34-66541, 2012 WL 759371, at *6 n.42 (Mar. 8, 2012).

Finally, in *Shaw* and *Levinson* (see *supra* at 11), the corporate defendants that the courts of appeals concluded had a duty to disclose or abstain were not close corporations; in fact, they were not even privately held. See *Shaw v. Digital Equipment Corp.*, 82 F.3d at 1199 (Digital Equipment Corporation was a "publicly held company"); *Levinson v. Basic,* 786 F.2d at 743 ("Basic's stock was traded on the New York Stock Exchange."). The courts of appeals in *McCormick* and *Rogen* (*supra* at 11) did not even mention whether the corporate defendants in those cases were close corporations, so there is no basis for concluding that those decisions turned on that fact. Thus, defendants are incorrect in their contention that only "close" corporations are required to disclose or abstain.

In any event, Stiefel Lab can be characterized as a closely held corporation. "The term 'close corporation' has been defined in various ways. It is often used to distinguish and set apart the corporation with only a few shareholders from the 'public-issue' or publicly held corporation. * * * Another popular definition states that a close corporation is a corporation whose shares are not generally traded in the securities market." O'Neal & Thompson, 1 *Close Corp and LLCs: Law and Practice* § 1:2 (Rev. 3d ed. Nov. 2012); *cf. Jelke v. C.I.R.*, 507 F.3d 1317, 1322

(11th Cir. 2007) (closely held corporations include corporations whose "shares are traded little, if any, in the marketplace"). Indeed, *Smith* employs the term "closely held corporations" to distinguish from "public corporations" (891 F.2d at 1574); Stiefel Lab was not a public corporation (Br. 1). Moreover, the definition of a statutory "close corporation" under state law, such as 8 Del.C. 342, is not determinative, in part because "the number of statutory close corporations is a small fraction of the number of corporations that fall within the other close corporation definitions." O'Neal & Thompson, 1 *Close Corp and LLCs: Law and Practice* § 1:4. See also *infra* at 19-22.

3. State law is not determinative of the duty to disclose or abstain under Section 10(b) and Rule 10b-5.

Contrary to defendants' contentions (Br. 20-22), because the Exchange Act is a federal statute, whether Section 10(b) and Rule 10b-5 impose a duty to disclose or abstain is a federal question and does not turn on the application of any one state's law. The Supreme Court instructs that "the antifraud provisions of the securities laws are not coextensive with common law doctrines of fraud," because "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89, 103 S.Ct. 683, 691 (1983). This Court has likewise explained that "[i]n exploring the question of whether a duty to disclose

exists in a particular situation, federal courts must go beyond state common law, and conduct an inquiry into relevant federal sources of authority." *Langford v. Rite Aid of Alabama, Inc.*, 231 F.3d 1308, 1313 (11th Cir. 2000) (mail and wire fraud).

Looking to federal law here does not result in any purported (Br. 21) "entanglement with state law." *Laird v. Integrated Resources, Inc.*, 897 F.2d 826, 836-37 (5th Cir. 1990). Since the duty to disclose or abstain found in federal court of appeals decisions interpreting Section 10(b) and Rule 10b-5 reflects a "developed federal standard it does not require reference to state corporate and securities law or the state law of fiduciary relationship," courts "may refer to these cases instead of state analogies," and "because state law is not considered, uniformity is promoted." *Id.* Indeed, exclusive reliance on state law would result in an undesirable lack of uniformity. See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 357-361, 111 S.Ct. 2773, 2779-2781 (1991) (recognizing the need for uniform rules under the federal securities laws).

In any event, even under Delaware state law (Stiefel Lab was incorporated in Delaware, Br. 20), a corporation repurchasing its shares cannot fraudulently omit material facts affecting their value. Although the Delaware Supreme Court has not

directly addressed this issue,[8] Delaware Chancery Courts have found that a corporation has a disclosure duty when repurchasing its shares. In *Eisenberg v. Chicago Milwaukee Corp.*, the Delaware Court found that "an issuer making a tender offer for its own shares is 'the most inside of insiders' and 'the insider par excellence,'" and thus has a duty to ensure that sellers are "fully, candidly and accurately informed of all material facts." 537 A.2d 1051, 1057-60, 13 Del. J. Corp. L. 1131, 1142-47 (Del. Ch. 1987) (granting preliminary injunction against corporate defendant), quoting *Broder v. Dane*, 384 F. Supp. 1312, 1318-1319 (S.D.N.Y. 1974). See also *In re Oracle Corp.*, 867 A.2d 904, 936-940, 30 Del. J. Corp. L. 568 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. 2005) (while corporations do not have a "general obligation" to disclose material information, "the disclose or abstain doctrine applies to issuers as well as to corporate insiders who wish to trade"), citing *Shaw*, 82 F.3d 1194 (1st Cir.). Notably, these Delaware state law cases look to federal law.

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[8] In *Arnold v. Society for Savings Bancorp, Inc.*, 678 A.2d 533, 65 USLW 2042 (1996), the Delaware Supreme Court recognized that while a corporation has no general duty under Delaware law to disclose any and all material information, under Delaware law a "disclosure duty owed by the corporation to its shareholder" can be "predicated upon a theory of legal or equitable fraud." 678 A.2d at 539 & n.11. In rejecting a state law claim arising out of a proxy statement, *Arnold* explained that even if a corporation is found not to have a disclosure duty under Delaware law, that corporation may have a disclosure duty under federal securities statutes that broadly apply to "any person." *Id.* at 539, discussing Section 14(a) of the Exchange Act, 15 U.S.C. 78n(a)(1).

Defendants suggest that under Delaware law the duty to disclose or abstain does not apply to any corporation unless it qualifies as a "close corporation" as defined by a Delaware statute, by having 30 or fewer shareholders. Br. 20-21, citing *Nixon v. Blackwell*, 626 A.2d 1366, 1379-80 (Del. 1993) and 8 Del.C. 342 (defining a statutory "close corporation" as a corporation with no more than 30 shareholders). Defendants are wrong for several reasons. First, *Nixon* is inapposite because it does not address a corporation's duty to its stockholder-employees or the duty to disclose or abstain. 626 A.2d at 1373-74, 1377, 1380-81. Second, *Nixon* itself makes plain that whether the corporation at issue is a "statutory close corporation" under the Delaware Code is not determinative. *Id.* at 1380 n.19, discussing 8 Del.C. 342; see also 8 Del.C. 356 (Delaware's close corporation statute does not repeal "any statute or rule of law which is or would be applicable to any corporation"). Third, the corporate defendants in *Eisenberg* and *Oracle* were not closely held; their shares were publicly traded. See *Eisenberg*, 537 A.2d at 1053, 13 Del. J. Corp. L. at 1135; *Oracle*, 867 A.2d at 907-909. Finally, defendants' position so elevates form over substance as to confer a duty to disclose or abstain on a corporation composed of 30 shareholders, but not on a corporation composed of 31 shareholders—a plainly unreasonable result.

4. A privately held corporation is not legally barred from fulfilling its duty to either disclose or abstain when repurchasing its shares from its stockholder-employees on the basis of material, non-public information.

There is no basis for defendants' assertion that Stiefel Lab was legally disabled from either disclosing or abstaining when repurchasing its shares from its stockholder-employees on the basis of inside information. See *Dirks v. SEC*, 463 U.S. 646, 653 & n.12, 103 S.Ct. 3255, 3260-61 & n.12 (1983).

a. Disclosure

Privately held corporations repurchasing their shares can disclose material information to seller stockholder-employees prior to buying back their shares. Disclosure would enable a stockholder-employee to make an investment decision on the basis of information important to making that decision. Contrary to defendants' contentions, this would not necessarily require a "public" disclosure that could potentially be disruptive of, for example, a potential merger (Br. 17, 22-26), as disclosure needs to be made "only to the person whose stock is to be acquired." *Jordan*, 815 F.2d at 431, 434 ("the firm need tell only the few investors from whom it buys stock during the negotiations"). There is no reason why privately held corporations, unlike close corporations, are somehow powerless to "extract promises of confidentiality" from seller stockholder-employees, or why such agreements require *literally* "face-to-face" negotiations. Br. 24-25. Such

confidentiality agreements can bind even former employees or non-employees. *E.g.*, *Roton Barrier, Inc. v. Stanley Works*, 79 F.3d 1112, 1115-19 (Fed Cir. 1996). By signing such a confidentiality agreement, former employees or non-employees thereby also become subject to liability under the federal securities laws should they disclose the information, such as through tipping, or if they otherwise trade on the information. See Rule 10b5-2(b)(1), 17 C.F.R. 240.10b5-2(b)(1); *SEC v. Yun*, 327 F.3d 1263, 1272-73 & n.23 (11th Cir. 2003).

b. Abstention

Alternatively, privately held corporations can abstain from repurchasing their shares on the basis of material non-public information. Defendants erroneously suggest that they were unable to abstain from repurchases due to their obligations under their employee stock ownership plan and the Employee Retirement Income Security Act (ERISA). Br. 22-23, 36-44. Specifically, defendants contend that they faced obligations to immediately repurchase shares, for example from terminated employees, and could not impose a "blackout period" on such repurchases from stockholder-employees without giving them 30 days' notice. See Br. 36-44, discussing 29 U.S.C. 1021(i).

But ERISA includes an express exception that permits repurchases to be suspended without instituting a "blackout period," and without requiring 30 days'

notice, because a "blackout period" does not include "a suspension, limitation, or restriction which occurs by reason of application of the securities laws (as defined in section 78c(a)(47) of Title 15)." 29 U.S.C. 1021(i)(7)(B)(i). The disclose-or-abstain rule for insider trading fits comfortably within this exception because that rule is a longstanding "limitation" or "restriction" on purchases and sales of securities. See *United States v. Cassese*, 428 F.3d 92, 105 (2d Cir. 2005) (ban on insider trading is a "trading restriction of Rule 10b-5"); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848, 860 (2d Cir. 1968) (*en banc*) (duty to abstain from trading acts as a "prohibition against purchases").[9]

There is no basis for defendants' interpretation of this ERISA exception as applying only to "trading suspensions" specifically authorized by the Commission due to a crisis or emergency under Section 12(k)(1) of the Exchange Act, 15 U.S.C. 78*l*(k)(1). See Br. 40-41 & n.37. Defendants' reading is erroneous for three reasons:

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[9] Defendants are likewise wrong that the Internal Revenue Code (26 U.S.C. 409(h)) prevented them from abstaining because it required Stiefel Lab to repurchase shares within 60 days from an employee-stockholder's request to sell. Br. 43-44. There is an exception for any period during which a company is unable to honor that request "by applicable Federal or state law." 26 C.F.R. 54.4975-7(b)(12)(ii). See also Michael B. Snyder, 3 *Compensation and Benefits* § 38:104 (May 2013). The disclose-or-abstain rule is applicable federal law and thus falls within this exception.

First, the ERISA exception expressly cross-references the full panoply of securities laws, including Section 10(b), not just the one subsection of one Exchange Act provision to which defendants point. See 29 U.S.C. 1021(i)(7)(B)(i) (exception) and 15 U.S.C. 78c(a)(47) (definition of "securities laws").[10]

Second, the provision defendants identify refers only to trading "suspensions." Defendants' cramped reading would render surplusage the statutory terms "limitation" and "restriction." This offends the "cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW Inc. v. Andrews*, 534 U.S. 19, 31, 122 S.Ct. 441, 449 (2001); accord *Nat'l Ass'n of State Utility Consumer Advocates v. FCC*, 457 F.3d 1238, 1257 (11th Cir. 2006).

Third, defendants' interpretation would permit employee stock ownership plans to offer even patently fraudulent investments (*e.g.*, "prime bank" instruments), for a full 30 days after learning the nature of such investments.

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[10] 15 U.S.C. 78c(a)(47) provides: "The term 'securities laws' means the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Sarbanes-Oxley Act of 2002, the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b et seq.) [15 U.S.C.A. § 80b-1 et seq.], and the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)."

Defendants' interpretation would thus require persons to violate the securities laws and perpetuate a fraud in order to comply with ERISA. Courts have rejected such an interpretation because ERISA should not be read to encourage fraud and deceit. See *In re Enron Corp. Securities, Derivative & ERISA Litig.*, 284 F.Supp.2d 511, 565-567 (S.D. Tex. 2003); *In re WorldCom, Inc.*, 263 F.Supp.2d 745, 767 (S.D.N.Y. 2003). See also Rachal Shapiro, *et al*., *ERISA Fiduciary Duties Regarding 401(k) & ESOP Investments in Employer Stock*, SU014 ALI-ABA 113 (Oct. 2012) ("[*N*]*o one*—the courts, the DOL [Department of Labor], or the Securities Exchange Commission ('SEC')—would allow fiduciaries or participants to trade while in the possession of material, nonpublic information."), original emphasis. A corporation can instead satisfy its duties under both ERISA and the securities laws by abstaining from trading.[11]

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[11] The Commission does not seek deference for its interpretation of 29 U.S.C. 1021(i) under *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778 (1984), because this provision—although promulgated as part of the Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (Section 306)—is administered by the Department of Labor. See *Final Rule Relating to Notice of Blackout Periods to Participants and Beneficiaries*, 68 FR 3716-01, 2003 WL 158515 (Jan. 24, 2003). The Commission's interpretation is based on the text of the provision and its interplay with the federal securities laws. Likewise, the Commission does not seek *Chevron* deference for its interpretation of 26 U.S.C. 409(h).

III. Although a merger is an event of significant magnitude, affirming the jury's verdict here would not require the Court to conclude that all pre-merger discussions are material as a matter of law.

The Commission will not delve into the facts regarding materiality that were presented to the jury in this private action because materiality is an "inherently fact-specific" inquiry (*Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309, 1318 (2011), quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 236, 108 S.Ct. 978, 986 (1988)), and materiality "assessments are peculiarly ones for the trier of fact," (*TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450, 96 S.Ct. 2126, 2133 (1976)). Accord *SEC v. Morgan Keegan & Co., Inc.*, 678 F.3d 1233, 1245-46 (11th Cir. 2012); *SEC v. Ginsburg*, 362 F.3d 1292, 1302 (11th Cir. 2004). This brief addresses only: (a) defendants' erroneous view that upholding the jury's presumed finding that the pre-merger discussions here were material would require this Court to endorse an overinclusive, bright-line standard under which *all* pre-merger discussions are material as a matter of law, and (b) defendants' failure to recognize that a merger is an event of significant magnitude.

A. Affirming the jury's presumed finding that the pre-merger discussions in this case were material does not mean that all pre-merger discussions are material as a matter of law.

Defendants err to the extent that they argue that if the Court were to conclude that there is evidence presented below from which a rational jury could

find that the particular merger discussions here were material, then "*any* discussions about potential mergers or similar deals" would be material as a matter of law. Br. 2, original emphasis; Br. 18 (arguing that liability here would require disclosure of "*all* preliminary merger discussions"), original emphasis. Only *material* merger negotiations need be disclosed, and materiality is a fact-specific inquiry that depends on the "total mix" of information available "under all the circumstances" in any particular case. *TSC Indus.*, 426 U.S. at 449-50. As this Court explained in *SEC v. Morgan Keegan*, "[w]hether merger discussions in any particular case are material . . . depends on the facts." 678 F.3d at 1246, quoting *Basic*, 485 U.S. at 239, 108 S.Ct. at 987. Likewise, misrepresentations and omissions regarding share valuation are actionable only if they are material under the circumstances. See *SEC v. MacDonald*, 699 F.2d 47, 48-50 (1st Cir. 1983) (*en banc*); *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 766-71 (11th Cir. 2007).

B. Under the probability/magnitude standard for materiality, a merger is an event of significant magnitude.

Although pre-merger discussions are not *per se* material, defendants fail to recognize that with regard to the materiality standard's balancing of both the quantitative "probability that the event will occur" and the qualitative "magnitude of the event" (*Basic*, 485 U.S. at 238-39, 108 S.Ct. at 987), a merger is an event of substantial qualitative magnitude. Indeed, the Supreme Court has noted that

"a merger in which it is bought out is the most important event that can occur in a small corporation's life." *Id.*, quoting *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976) (Friendly, J.). This Court has likewise explained that a "merger is an event of considerable magnitude to an investor." *Ginsburg*, 362 F.3d at 1302. See also *SEC v. Warde*, 151 F.3d 42, 47 (2d Cir. 1998) (materiality of a takeover is "not open to doubt"); *SEC v. Obus*, 693 F.3d 276, 289-290 n.3 (2d Cir. 2012) ("Unannounced acquisitions are a prototypical example of material non-public information."); *SEC v. Maio*, 51 F.3d 623, 628 n.3 (7th Cir. 1995) (same). Accordingly, discussions regarding a merger "can become material at an earlier stage than would be the case as regards lesser transactions." *Basic*, 485 U.S. at 238, 108 S.Ct. at 987.

CONCLUSION

In reviewing the district court's judgment and jury verdict against defendants, this Court should apply the legal interpretations set forth in this brief.

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June 2013

CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(c)

I hereby certify that, this brief complies with the type-volume limitation of Fed. R. App. P. 29(d) and Fed. R. App. P. 32(a)(7)(B)(i) because it contains 6,927 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), and this brief complies brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Office Word 2010 in 14-point Times New Roman.

Dated: June 5, 2013

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I also certify that, on the same day, I served the Brief of the Securities and Exchange Commission as *amicus curiae* on all counsel of record identified below by electronically filing using the CM/ECF system, and also sent two paper copies to be sent by overnight delivery to:

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