HOW TO HIDE IN A FISH BOWL: STREET-SMART GUIDE TO PRIVATE COMPANY INVESTOR DISCLOSURE

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Deals involving shares and shareholders can trap companies in a maze of investor disclosure rules. Whether a firm sells shares or bonds, or requests owners' permission to vote at shareholder meetings, the law demands that an entity reveal its finances, operations and weaknesses to securities holders.

Management must fulfill obligations under the law to disclose significant information, but common business sense requires no compromise of competitive or operational advantages through excessive openness. Just as most people hesitate to disclose their private lives to just anyone anywhere, so also should a business exercise discretion.

Privately-held companies operate under requirements that differ from those of publicly-held peers. Fortune 500 firms trading on public securities exchanges have the benefit (and the burden) of clear but copious disclosure requirements. However, non-traded private companies, regardless of the number of shareholders, can feel themselves entwined in a vague and confusing thicket of dictates from judges and bureaucrats. These smaller firms operate under general rules of fraud and fairness, as opposed to compliance with the bright-line tests applied to publicly-traded firms.

The stakes are high. If an investor convinces a judge that the company withheld or misstated information, the firm can be held liable for at least the return of the investment. If one shareholder proves liability, often all shareholders can receive compensation from the firm. The worst case scenario can include both bankruptcy for the company and personal liability for management.

The When of Disclosure

Securities laws apply when firms take certain actions, including selling stocks or bonds, sending letters to securities holders, requesting permission to vote shares on behalf of owners, delivering periodic financial statements, or repurchasing stock from current shareholders. Apart from these actions, a firm can function in a secure zone of corporate silence.

The Why of Disclosure

The threat of a law suit based on fraud underlies the rationale and scope of most corporate disclosure. The elements of such claims establish the parameters of appropriate privacy. First, any misstatement must be material. That is, was there "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available." Second, the company must be shown to have intended to deceive investors; "intent," however, can arise from innocent recklessness, where the company should have known that its statements would mislead.

Unfortunately, even after thousands of rulings over the years, judicial standards offer little more guidance than a Zen riddle. Both courts and government agencies retreat to the "standard" that the relevance of any company statement or action depends on the facts and circumstances of the company, the market, and the current and potential investors. For instance, a large, complex company may require more explanation than a single-asset or single-product firm. Similarly, if the firm approaches dozens or hundreds of unsophisticated potential purchasers, disclosure must be clear and complete. On the other hand, if a company targets only sophisticated institutional venture capital investors, disclosures can be limited, and liability limited, since the venture fund's staff usually completes its own thorough due diligence.

Rulings, pronouncements, law suits and regulatory commentary offer the tea leaves about disclosure standards, methods and timing. By following a few principles, companies can better gauge what to share in public and what to retain in private.

The How of Disclosure

Companies should appreciate what documents and communications trigger liability. Fraud claims arise from any medium of communication. Most commonly, when a firm sells shares or bonds, a prospectus or private placement offering memorandum provides the information about the company and a transaction. Sales materials might also include PowerPoint slides. Speeches can expose management to claims of false statements as much as the black and white text of any offering document. Less common, but just as legally lethal, advertisements can trip over the rules regarding accuracy and completeness.

Executives can manage the challenge through two practical approaches. First, each recipient of offering materials can be required to execute a confidentiality agreement. For existing shareholders, this could be included in a shareholder's agreement that survives as long as the investor holds an interest in the firm. Second, the company could simply target fewer potential purchasers, and instead contact only serious corporations and venture funds. This allows the company to skip the mass mailing of the prospectus to distant "contacts," many of whom are more likely to abuse the information than purchase shares.

A third option is less practical: simply hide the information. Companies can get away with this practice when shareholders are repaid with a fair return. The risk arises in the common instance where investors lose some or all of an investment. In such cases, the "disclosure safety net" may become the difference between financial life and death for the firm.

The What of Disclosure
The bottom line — what can management say? What should they say? What should they omit? Following are basic categories of disclosure which would be included in a prospectus to stock purchasers. A supplemental letter to shareholders would include only those facts new to shareholders and relevant to the action taken, such as voting on director appointments.

Business basics. For a stock or bond offering prospectus, documents should almost always address the following business basics: business description; competition; market; assets; intellectual property; suppliers; customer concentration; method of production; marketing plan and strategic relationships; significant industry-specific regulations; research and development; liquidity and the period of time until the firm will need more cash; expectations of timing of cash-flow positive operations; future capital investments; company history and basic organization; milestones regarding product development, distribution or sales; management biographies, including directors; and inside deals and arrangements with officers, directors, significant shareholders and their families, or entities that any of these persons control; management compensation and employment terms; uses of funds of offering, including expenses and commissions related to the offering.

Contingent liabilities - meaning of maybe. Among the thorniest of issues is the description of events and liabilities with uncertain outcomes. Top of the list — litigation. First, assess the worst case or best case scenario. Regulators have used a rule-of-thumb disclosure standard of ten percent of the assets of the entity. Second, consider the likelihood of the outcome. Generally speaking, the likely outcome will fall into one of three categories — highly likely (95 to 99 percent), highly unlikely (zero to five percent), or “your guess is as a good as mine.” If the litigation is material and the result other than highly unlikely, then disclosure may be prudent. Other contingent liabilities to consider include negotiations of significant transactions.

Proof is in the exhibits. Private company offering guidelines do not require that companies provide specific exhibits such as bylaws, articles and significant agreements. However, for smaller privately-held firms, providing these documents is an efficient means of ensuring adequate disclosure without risk of omitting a critical sentence in the offering documents. Early-stage companies often make everything available, given the relatively small number of documents. Smaller firms might follow regulators’ large-company guidelines when selecting which exhibits to provide or to make available at the firm’s offices.

Measure of materiality. Nothing frustrates management more than the “it depends on the facts and circumstances” proviso of the disclosure laws. Regulators and courts, however, have provided hints about quantitative benchmarks for disclosure. For example, for contingent liabilities, firms might use a standard of ten percent of assets; for material contracts, one to five percent of revenue; for everything else, a standard of one to three percent of revenue should work. Firms can often omit the truly routine low-dollar contracts, such as basic agreements relating to administration and office management. Note that practically any agreement with a non-competition covenant or other non-quantifiable but significant obligation should be disclosed, especially for smaller companies.

TIP: Many savvy early-stage clients bypass the handwringing and disclose everything, deciding it's simply not worth the trouble to separate the tiny from the small. If you try to slice the miniature onions and tomatoes, you'll only cut your finger. It may be better to simply put all of these small documents into the disclosure salad.

Magnifying the fine print of governance documents. Offering documents should describe the dull, but financially essential, terms of the stock or debt being sold. This includes voting rights, conversion options, prepayment penalties, coupon interest rates, and all other rights and obligations of the holders that directly and materially affect the terms of the investment. Such documents include the certificate of incorporation, bylaws, shareholders agreements, promissory notes and other documents directly describing the rights and obligations of the holders. Experienced investors and firm management usually appreciate what constitutes "material" for purposes of this disclosure: would the provision in the corporate document significantly affect them if they, themselves, purchased the investment? Or, more pointedly, whether they would put the money of their parents or their children in the shares or bonds being sold.

The risk list. Initially mandated by statute, but now acknowledged as common industry practice, is a series of one-paragraph descriptions of risk factors. In theory, these should be customized for every offering. In practice, the following risk factors should probably be included in every offering: dependence on key personnel; regulatory restrictions on business practices; competition; intellectual property weaknesses; insufficient cash; litigation; concentration on customers or suppliers; lack of demand for new company technology; failure to develop new products; labor disputes; (for newer companies) lack of operating history; operational inefficiency and disorganization following a significant transaction; lack of market liquidity for the securities (this is commonly missed); potential per share dilution in future offerings; lack of dividends; a lack of control by purchasing shareholders when compared with current controlling shareholders.

Puff the magic disclosure. Like a parent crowing about his kid's good grades, offering documents commonly include overly positive "puffing." Courts have often found no harm in these overly optimistic claims, such as a belief that a product will become the most profitable in the portfolio, or that a future distant market will massively boost revenues. However, beware of statements such as "best in class," "leading edge technology" or "guarantied profit." Best to keep the disclosures tempered and clinical, not ecstatic and theatrical.

Show me the money - financial statements. No other disclosure exposes management to liability more than an inaccurate balance sheet or income statement of an entity. Accurate financials are the "must-have" attachments. If audits are financially practical, these can reduce the chances of a mistake and better insulate management and directors from shareholder liability. While two or three years of financial statements help, early-stage firms may provide one year, or skip the statements altogether in the case of a start-up.

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