Ways to Limit Secondary Sales In Your Company's Stock – a Blog Post by David Goldenberg

The market in private company stock has exploded in recent years. As your company grows, you may see demand from third parties to buy stock from your existing stakeholders. Keeping control of your capitalization is critical so you don't lose control of your company. A few thoughts and tips below.

Buy low, sell high. It is an investment axiom. Growth and hypergrowth companies have shown everyone that amazing returns can be made by investing early in companies that go on to become great. Everyone wants the opportunity to buy into a company before it truly gets hot in hopes of finding a massive return on their investment later.

This basic principle is a key driver in the secondary sales market, which can happen well before a company goes public. Here's what separates a secondary sale from a primary sale:

Primary: The company issues stock to investors, and that money goes directly into the company.

Secondary: The stock is not newly issued. An investor buys shares from a current stockholder, and the transfer of money would go to the seller rather than to the company itself.

When an investor cannot participate in a company's financing round (primary sales), they may try other ways to obtain equity, including purchasing from existing investors. In fact, there are now entire funds with the sole investment thesis of investing in secondary sales.

There are a variety of reasons why a company may not want secondary sales going on for their stock, especially if they haven't gone public yet. In some cases, it may be legal regulations, like a company only being allowed to have a limited number of stockholders before going public. In other cases, it may be a case of simply not wanting control of your stock in the hands of unknown stockholders (or worse, competitors). Fortunately, there are ways to limit the secondary sales of your company's stock.

Right of first refusal: In general, companies should have a legal clause that allows the company to buy back the stock from anyone trying to do a secondary sale of stock. Depending on the timing and terms, this may not be an ideal solution for the company (as the company will have to use its own funds / money from investors to try and buy back stock). However, it is a low risk and very effective method to keep control of your company's stock.

Limiting Information: Companies can also take steps to limit the information about the company that is known to third parties. Investors need information about the company to determine a purchase price. If you can limit this information, purchasers may be less interested in purchasing the company's stock. However, there are times when information must be provided, so be sure that you've discussed this with a lawyer first.

Restrictions on Resales: There are also restrictions on resales which can be adopted in different circumstances. For instance, companies can put in prohibitions on resales without board consent. It is also common to restrict sales by insiders for 6 months after an IPO.

Proactive Steps: Companies should consider their stakeholders' motivation for selling. In some cases, if a company is on the rise, but still privately held, its stock may present a valuable, albeit illiquid asset. If early stakeholders (for instance early employees or investors) have been holding a long time, they may want to cash out earlier. If you suspect that this may be an issue, it may be worth it to try and address the issue by reaching out to the employees (or even creating a liquidity program within the company) rather than trying to stop all sales.