

## Secondary sales

Early stage companies are generally closely or privately held, and underlying shares are neither registered with the Securities and Exchange Commission, nor listed or traded on a securities exchange. Accordingly, startup founders and employees may have equity securities, such as founder shares or stock options, of substantial value on paper, with no easily accessible market upon which to obtain any liquidity. This article highlights special considerations relating to lawful sales of private company securities to third parties.

### What is a "secondary sale"?

A secondary sale is a sale by an existing stockholder to a third-party purchaser, the proceeds of which benefit the selling stockholder. This is in contrast to a "primary" issuance, in which the company is selling its stock to an investor and using the proceeds for corporate purposes.

### What are some considerations for parties participating in secondary sales?

- **Securities laws.** Because the shares to be transferred are not registered on an exchange, the transfer of securities must comply with applicable federal and state securities laws. It is important that secondary sales not be viewed as an underwritten offering of securities by the company. Relevant to the analysis are such factors as how long the seller has held the stock, availability of relevant information to a buyer and whether the buyer is an "accredited investor."
- **Contractual restrictions on transfer.** Private companies frequently impose restrictions on transfer as a matter of contract when issuing shares. Sellers must review the documents they signed or instruments by which they are bound (eg, in a company's bylaws or certificate of incorporation, or a company's insider trading policies if the selling stockholder is an employee) to determine if there are obstacles to transfer unique to the company.
- **Company cooperation.** The company's cooperation is a key practical consideration, because buyers generally pay more when they have greater insight into the company's recent performance, financial condition and projections and often shy away altogether from transactions where such information is unavailable or cannot be verified.
- **Information.** On the one hand, selling stockholders may have agreed as a matter of contract not to share confidential information of the company with third parties, and such restrictions may limit what a selling stockholder can say to a prospective buyer. At the same time, however, insider trading rules do apply to sales of private company stock, so sellers must consider carefully whether they have material, nonpublic information which the buyer does not possess.
- **Pricing.** Compliance with securities and transfer restrictions, company cooperation and readily disclosable information will all help to reduce the illiquidity discount generally applicable in secondary sales of privately held company stock, and help buyers and sellers get better pricing and a better deal.

### What are some considerations for companies whose stock is subject to the secondary sale?

- **Company and third-party rights.** As noted above, sellers may be bound by restrictions on transfer, such as rights of first refusal in favor of the company or third party investors, or "co-sale" obligations to allow third parties to sell shares to buyers on the same terms as have been agreed with a seller. Companies may wish to exercise their rights or assign them to a friendly third party (eg, to prevent a buyer from becoming a stockholder), but in all instances will want to ensure that a seller's obligations have been satisfied in full (or properly waived).
- **Distraction and fairness.** As noted above, a company receives no direct benefit from a secondary sale, and while companies often accommodate requests for support from key investors and service providers, such accommodations can set expectations among other stockholders regarding the level of support they can anticipate receiving should they propose a transaction. Management can easily be distracted from important operational matters, which can impede the company's progress and growth.
- **Cost.** Evaluating compliance with applicable law and documentation, gathering and disseminating information, and reviewing and approving transfer documentation, including legal opinions that may be provided in connection with the transaction, do impose out-of-pocket and opportunity costs on the company. Frequently, companies impose a transfer fee to ensure that one or both of the parties to the transaction will defray such costs.
- **Protecting confidential information.** To the extent a company does wish to ensure that the parties to a secondary sale each have some fundamental information on which to base a decision to sell or buy company securities, the company should provide this information using the protections of a non-disclosure agreement, so that the information will not be shared with others or used for any purpose other than evaluating the potential transaction. For more about non-disclosure agreements, [please see our article](#).
- **Impact on option pricing.** Companies generally rely on 409A valuations for determining the fair market value of the company's stock when fixing the exercise price for options granted to employees and other service providers. Depending on a variety of factors, secondary sales could affect a board's view as to whether a 409A valuation is properly reflective of true fair market value for such stock.

A limited pool of buyers, a dearth of publicly available information for potential investors and companies' desire to avoid the risks and distraction posed by secondary sales means that sales of private company securities are not regular occurrences. However, managed carefully, such transactions can be executed for the collective benefit of sellers, buyers and companies.

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