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SEC Sues Private Company and its CEO for Fraud Related to Buyback Program Involving Employee Stock Bonus Plan

by Jonathan Boyles and Ashley McCarthy

Overview of the SEC's Complaint

On December 12, 2011, the U.S. Securities and Exchange Commission (SEC) filed suit in the U.S. District Court for the Southern District of Florida against Stiefel Laboratories, a family-owned dermatological products business that was acquired by GlaxoSmithKline (GSK) in 2009, and against Charles Stiefel, the company's former chairman and CEO. The SEC has statutory standing to bring anti-fraud claims under Section 10(b) of the Securities and Exchange Act of 1934 (the Exchange Act). Prior to the acquisition, Stiefel Laboratories was the world's largest private manufacturer of dermatology products, with annual revenues of $1 billion and approximately 4,000 employees. Stiefel and his family owned the majority of company shares.

The SEC complaint alleges that the defendants defrauded Stiefel Laboratories' shareholders by buying back shares of company stock at significantly undervalued prices and by misleading the company's shareholders regarding the CEO's intent to sell the company. In the SEC's estimation, shareholders lost approximately $110 million as a result of the alleged fraud.

According to the SEC's complaint, as discussions with potential investors and buyers intensified, the defendants egregiously undervalued and aggressively repurchased shares of company stock that had been issued to employees pursuant to the Stiefel Laboratories Employee Stock Bonus Plan. In addition, Stiefel Laboratories retained a third-party accountant to conduct its annual valuation, which served as the basis for the buyback price that it offered to Employee Stock Bonus Plan participants, rather than a valuation firm or other professional appraiser. In the SEC's view, this failure to engage a valuation firm or other professional appraiser constituted a breach of the CEO's duty as plan trustee to obtain accurate valuations of the company's stock. Further, the SEC's complaint alleges that the CEO purposely withheld information from employees and the accountant that would have indicated the stock was worth more than the buyback price being offered. The fraudulent objective, according to the SEC, was to maximize the personal profits available to the company's top executives following the sale of the company. Aside from the shares held by Stiefel family members, most company stock was held by employees through the Employee Stock Bonus Plan.

The Company's Allegedly Fraudulent Undervaluation and Buyback Scheme

Each year, Stiefel Laboratories engaged an accountant to value the company's stock for the prior fiscal year. The accountant did not routinely conduct similar valuations for other companies. The company provided financial statements and other information to the accountant for use in the valuation. The accountant's valuation was then communicated to employees and served as the basis for the buyback price.

According to the SEC, the Employee Stock Bonus Plan and its summary plan description clearly state that the CEO (acting as plan trustee) was required to obtain accurate company valuations for any purpose under the plan, including buybacks. The SEC alleges that the CEO violated this legal duty by failing to disclose numerous investment and acquisition offers that the company received between 2006 and its acquisition by GSK and by affirmatively denying to Employee Stock Bonus Plan participants rumors that acquisition negotiations were underway.

The table below illustrates the buyback price per share that Stiefel Laboratories offered its employees during the years leading up to the sale to GSK as well as the pertinent information that the SEC alleges the defendants withheld from the valuation processes.

Year	Buyback Price (Per Share)	Confidential Information Not Incorporated in Valuation
2006	$13,012	Five investment firms make offers to acquire $200 million of Stiefel Laboratories preferred stock based on valuations ranging from 50 percent to 200 percent greater than the valuation used to establish the buyback price. Stiefel Laboratories did not accept investment offers as it believed investors did not assign high enough valuation to its shares.

2007	$14,517	Stiefel Laboratories receives investment bids based on equity valuations ranging from $1.9 billion to $2.6 billion (or approximately $42,000 to $60,000 per share). Stiefel Laboratories accepts BX Healthcare's $500 million investment in exchange for a 19 percent interest in the company based on a $2.6 billion valuation ($60,000 per share or approximately 400 percent higher than the buyback valuation).
2008	$16,469	Stiefel Laboratories seeks acquisition bids. Investment firm advises the company to expect sale price of $3 billion to $5 billion based on valuations ranging from 310 percent to more than 500 percent greater than the valuation used to establish the buyback price. Stiefel Laboratories amends the buyback scheme to permit buybacks from current employees for the first time in company history and misleadingly touts the amendment as intended to permit employee portfolio diversification. Stiefel Laboratories implements a long-term incentive plan, which awards additional stock and golden parachutes to 16 senior executives.
2009		GSK purchases Stiefel Laboratories for $2.9 billion at $64,933 per share (300 percent higher than average buyback price over the past three years).

Throughout the investment and acquisition negotiations referred to in the table above, Stiefel Laboratories aggressively repurchased shares of stock from Employee Stock Bonus Plan participants. According to the SEC complaint, these buybacks were based on inaccurate valuations that the accountant produced without knowledge of the investment and acquisition offers and the substantially higher valuations that accompanied these offers. The complaint also alleges that the accountant was not qualified to conduct stock valuations.

Following the sale to GSK, the company paid its Employee Stock Bonus Plan shareholders $68,131 per share and its non-plan shareholders, including several members of the Stiefel family, $64,933 per share of company stock. An additional $100 million was placed in an escrow account for indemnification purposes and any unused portion of this amount will ultimately be distributed to non-plan shareholders as well. As indicated in the table above, the company had only offered Employee Stock Bonus Plan shareholders prices ranging from $13,012 per share to $16,469 per share for buybacks executed between March 2006 and April 2009.

According to the SEC, Stiefel Laboratories' failure to obtain an accurate valuation for purposes of the buyback scheme and its systematic denials that investment and acquisition negotiations were underway, together with its aggressive buy backs and ultimate sale of the company, constituted fraud under Section 10(b) and Rule 10b-5 of the Exchange Act. The SEC's complaint seeks permanent injunctive relief, the disgorgement of ill-gotten gains with prejudgment interest, other financial penalties, and an officer and director bar against the CEO.

Outstanding ERISA Complaints Brought by Plan Participants

In addition to the SEC complaint, the defendants and other senior company executives are currently named in suits brought by Employee Stock Bonus Plan participants. In addition to fraud claims alleged in the SEC complaint, the participant lawsuits allege violations under the Employee Retirement Income Security Act (ERISA). These Plan participants sold their stock back to the company prior to the sale to GSK, but subsequent to the company's alleged realization that its stock was worth more than the buyback price suggested.

According to these participant complaints, the CEO and other senior executives were Employee Stock Bonus Plan fiduciaries and breached their general fiduciary duty under ERISA to operate the plan prudently and in the best interests its participants. More specifically, these complaints allege that the plan fiduciaries breached their duty to obtain a good faith valuation of the company stock from an independent appraiser who customarily conducts such valuations. According to the complaints, the accountant engaged by the defendants to conduct the annual valuation was not qualified for this task, as evidenced by the accountant's failure to hold himself out as an appraiser of equities and the substantial disparity between his valuations and the share valuation pursuant to the investment and acquisition offers.

The participant complaints allege that the Employee Stock Bonus Plan fiduciaries further breached their ERISA duty to obtain a good faith valuation of the company stock by intentionally withholding information material to the valuation process, as summarized in the above table. One of these participant complaints, Bacon v. Stiefel Laboratories, is currently scheduled for jury trial on May 7, 2012. One participant lawsuit was dismissed because the participant had signed a general release in exchange for a transaction bonus upon closing of the sale to GSK and the general release barred the ERISA suit.

What the SEC's Complaint Means for Other Companies

The SEC's complaint in this matter underscores the broad reach of the anti-fraud provisions of the federal securities laws and signals the SEC's intent to enforce those laws against public and private companies alike. Executives should note that compliance challenges are heightened where a company is repurchasing its own stock, because regulators are attuned to the potentially steep imbalance of information that a company possesses with respect to the true value of its own stock. In fact, some commentators have suggested that Rule 10b-5 may, in some cases, serve as an absolute bar to trading where the information disparity between a company, on one hand, and owners of the company's stock, on the other hand, cannot be overcome because the company's management is aware of confidential information that it cannot legally disclose and that substantially alters the stock's valuation (i.e., an impending acquisition).

Further, the Stiefel Laboratories case indicates that reliance on a third-party valuation does not inoculate a company against Exchange Act liability. Stiefel Laboratories suggests that, beyond merely engaging a third-party to appraise the company, companies must ensure that they engage a qualified valuation expert who routinely performs valuations and that they provide the valuation expert with all information pertinent to the valuation, such as offers to invest in or buy the company. Further, companies should obtain updated valuations where intervening developments, such as credible offers to buy the company, render previously obtained valuations out of date.

Companies should also note the SEC's observation that the summary plan description required the CEO, as plan trustee, to obtain an accurate valuation of company stock. Although recent case law indicates that the terms of a summary plan description do not trump the terms of a plan document for purposes of applying ERISA, the SEC's reliance on the summary plan description indicates that, as a practical matter, statements contained in a summary plan description will still factor in factual assessments of companies' fulfillment of their duties under the securities laws. Companies should remain vigilant in drafting, reviewing and updating as necessary their summary plan descriptions and other plan communications.

Companies should avoid having responsibility for equity plan administration and company management concentrated among a few executives, especially in the absence of independent oversight. Notably, Stiefel acted as a plan fiduciary and plan trustee. There was no corporate or otherwise independent trustee. Stiefel also served as chairman, CEO, a member of a compensation committee without any independent directors, and held voting rights to name the entire board.

In addition, public companies contemplating acquisition of private company targets would be well-advised in the wake of the Stiefel Laboratories complaint to broaden the scope of their due diligence investigation of the target company's equity plans and, in particular, the basis for any valuations of those equities. Where an acquirer assumes a target's equity plans, that acquirer is exposed to liability under the plans for actions that may predate the acquisition, such as the alleged undervaluation at issue in this case.

Finally, companies should proceed with caution in administering equity-based employee benefit plans where they possess material information that is not yet available to plan participants. As indicated by the ERISA complaints described above, exposure is not limited to Exchange Act liability where equity-based employee benefit plans trigger additional and stringent ERISA duties.

The *Fiducie* in Restructuring and Acquisition Transactions in France

by Thibaud Forbin and Jonathan Wohl

For years, the absence in the French civil law system of the concept of the trust hampered French lawyers involved in structuring complex secured financings and other transactions. Although common law trusts could be used in the context of off-shore transactions involving a French party, the device could not be used in a domestic French operation. In response, France enacted new legislation in 2007 introducing the concept of the *fiducie*.

Fiducie is defined as a "transaction by which one or more settlors (*constituants*) transfer assets, rights or security, either present or future, to one or more fiduciaries (*fiduciaires*) who, while maintaining those assets segregated from their own estate, act for a specific purpose for the benefit of one or more beneficiaries (*bénéficiaires*)." The *fiducie* creates a dedicated fiduciary estate (*patrimoine fiduciaire*) which is not subject to the claims of creditors of any party to the fiducie (including the fiduciary). The transfer of ownership of the fiduciary assets is temporary but the term can be as long as 99 years.

Only credit institutions, investment companies, insurance companies and members of the bar may be fiduciaries. The same party may act in several capacities in the context of a transaction. Thus the settler of the fiduciary estate or the fiduciary itself may be a beneficiary of the *fiducie*.

Intended Use of the *Fiducie*

The fiducie was designed to serve as a device by which a financial institution can take security over the assets of a borrower (security *fiducie*), as well as a vehicle for asset management (management *fiducie*). In the case of a security *fiducie* a debtor transfers assets to a lending bank that acts as a fiduciary on its own behalf. The fiduciary also signs a usage agreement with the debtor allowing the debtor to use the assets and requiring the debtor to take all risks with respect to the assets. At maturity of the loan, and provided that the debtor has fully performed its obligations, the assets are transferred back to the debtor. In case of default, the fiduciary can sell the assets in order to repay the financing. In the case of a management *fiducie*, a settlor entrusts assets to a fiduciary, either as a financial manager or simply as a stake-holder, to carry out a particular distribution arrangement (much like an escrow).

Accounting and Tax Treatment

In principle, the *fiducie* is neutral with regard to its accounting and tax treatment. The transfer of property to the fiducie does not give rise to capital gains (although, depending on the nature of the assets, there may be a transfer duty). The transfer does not necessarily diminish the value of the settlor's assets since it may include as an asset a claim against the fiducie in the same amount as the assets transferred. The transfer of assets to the fiducie is made without consideration and therefore is not subject to value added tax (VAT).

Advantages of the *Fiducie*

Although the law has been in effect for five years, the *fiducie* has been slow to gain widespread acceptance among banks as a preferred structure for secured transactions. Nonetheless the fiducie is being used as an innovative means to respond to specific situations arising in the course of restructurings and acquisitions.

The *fiducie* affords a number of advantages:

- the parties to the *fiducie* have the right to determine the conditions of the *fiducie* operation including, most importantly, those relating to the transfer, management and return or sale of the fiduciary assets;
- in the case of a security *fiducie*, the settler can "recharge" the fiduciary assets from time to time throughout the term of the fiducie at little cost, thus allowing for optimization of the security afforded by such assets; and
- the assets in a fiduciary estate are "bankruptcy-proof" with respect to the bankruptcy of any party to the arrangement.

The *Fiducie* in Action

Although, as mentioned above, banks have been hesitant to use the *fiducie* as a means of secured lending, it has proven its usefulness in a variety of restructuring and acquisition transactions.

For example, the *fiducie* has been used in connection with a voluntary restructuring to provide assurance to third-party creditors, whose claims against a debtor were being litigated, that proceeds of the restructuring would be available to pay their claims in the event that the litigation would be resolved in their favor.

In an acquisition where the seller agreed to fund the payment of substantial employee claims against the acquired company arising from a pre-acquisition redundancy plan, a fiducie was created by the seller to hold the necessary funds in a bankruptcy proof structure, thus providing assurances to both the employees and the seller that claims would be paid even in the event of the subsequent bankruptcy of the acquired company.

The flexibility of the *fiducie* could make it useful in other contexts as well, for example:

- If governmental approval is required as a condition to close an acquisition, but it is unlikely that it will be issued quickly (*e.g.*, approval from the competition law authorities), and the business must be transferred out of the seller's group within a relatively short time frame, a *fiducie* could be set up to hold the business pending completion of the approval process.
- Given the current uncertainty as to the financial condition of certain financial institutions, the fiducie can be used in place of an escrow arrangement to retain a portion of the purchase price in an acquisition, since it is clear that assets held in a *fiducie* are immune from claims of the creditors of the fiduciary.