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SEC Reaffirms the Broad Reach of Rule 10b-5 to Private Companies

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What You Need to Know: The SEC's recent enforcement action against a private company and its former chairman and chief executive officer for allegedly defrauding shareholders in connection with stock buybacks is an important reminder that the anti-fraud provisions of the federal securities laws apply to all securities transactions—whether the securities in question are issued by a public or private company.[1]

SEC's Recent Case: *Stiefel Labs*

On December 12, 2011, the SEC filed an enforcement action in the US District Court for the Southern District of Florida against Stiefel Laboratories Inc. (Stiefel Labs) and Charles Stiefel, the company's former chairman and CEO, alleging that they engaged in a fraudulent stock scheme in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.[2] The complaint alleges that Stiefel Labs, a private company founded in 1847, and Stiefel, defrauded Stiefel Labs' shareholders, who were mainly current and former employees of Stiefel Labs, out of more than $110 million by buying back shares of Stiefel Labs stock from those employees at "severely undervalued prices."[3]

In particular, during various periods of time over the course of two and a half years, Stiefel Labs and Stiefel allegedly failed to disclose material, nonpublic information that "would have alerted shareholders that their shares were worth much more than reported."[4] Stiefel Labs repurchased most of the employees' stock pursuant to Stiefel Labs' Employee Stock Bonus Plan (the Plan), a defined contribution plan, for which Stiefel served as trustee from 2001 until October 2008. Stiefel Labs engaged a third-party accountant to perform a valuation of Stiefel Labs' stock each year to establish the repurchase price that would be in effect for that year. The SEC alleges both that the third-party accountant used a faulty valuation method and that neither Stiefel Labs nor Stiefel informed him of material information regarding potential sales of, and investments in, Stiefel Labs. Specifically, Stiefel Labs is alleged to have:

- repurchased shares for $13,012 per share, the 2006 Plan valuation, after receiving offers from five investment firms to acquire Stiefel Labs at equity valuations that were 50% to

200% higher than the 2006 Plan valuation;

- repurchased shares for $14,517 per share, the 2007 Plan valuation, after receiving an equity valuation of approximately $2 billion from one private equity firm and selling convertible preferred stock to another private equity firm based on an equity valuation of $2.6 billion and purchased additional shares outside of the Plan at prices even lower than the 2007 Plan valuation, which was then in effect; and
- repurchased shares for $16,469 per share, the 2008 Plan valuation, while Stiefel Labs was running an auction process to sell itself, which ultimately resulted in a price per share of $68,131.

Eric I. Bustillo, the director of the SEC's Miami Office, stated in a press release that accompanied the filing of the *Stiefel Labs* case: "Private companies and their officers must understand that they are not immune from the federal securities laws, which protect all shareholders regardless of whether they bought stock in the open market or earned shares through a company's stock plan."[5]While *Stiefel Labs* is not the first SEC fraud claim against a private company,[6] Bustillo's comments send a clear message that transactions in private company securities may become the subject of SEC enforcement scrutiny.

Practice Considerations

Although the *Stiefel Labs* action highlights the highly fact-based nature of any fraud claim and the importance of the specific evidentiary chain in establishing that claim, it provides a stark reminder of the broad reach of the anti-fraud provisions of the US federal securities laws. *Stiefel Labs* sounds a warning to participants in transactions involving private company securities to comply with those anti-fraud provisions, specifically by not engaging in securities transactions while aware of material information regarding the private company that is unknown to the transaction's counterparty.

For public companies considering acquisitions of private company targets, *Stiefel Labs* suggests that the acquiror expand the scope of its due diligence investigation of the target company's equity securities to cover post-issuance transactions involving those securities and, in particular, the basis for the valuations used in transactions between an issuer and its stockholders.

Stiefel Labs also emphasizes the need for companies to provide all relevant information to the parties that companies engage to prepare an independent valuation and to ensure that the methodology employed in the valuation is appropriate.

Finally, *Stiefel Labs* calls attention to the need to consider issues that can arise in connection with equity-based employee benefit plans when the issuer of securities under the plan has material information regarding pending extraordinary events that is not yet known by plan participants.

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[1] See *Sec. & Exch. Comm'n v. Stiefel Labs. Inc.*, No. 11-cv-24438-WJZ (S.D. Fl. filed Dec. 12, 2011), available at www.sec.gov/litigation/complaints/2011/comp-pr2011-261.pdf.

[2] Stiefel Labs is contesting the SEC's civil charges. See Peter Lattman, *S.E.C. Accuses Stiefel Labs and Its Ex-Chief of Fraud*, NEW YORK TIMES, Dec. 12, 2011, available at www.dealbook.nytimes.com/2011/12/12/s-e-c-accuses-stiefel-scion-of-cheating-former-employees.

[3] See Complaint at ¶ 1, *Sec. & Exch. Comm'n v. Stiefel Labs. Inc.*, No. 11-cv-24438-WJZ (S.D. Fl. filed Dec. 12, 2011).

[4] Id. ¶ 28.

[5] Press Release, Sec. & Exch. Comm'n (Dec. 12, 2011), available at www.sec.gov/news/press/2011/2011-261.htm. When discussing the SEC's complaint against Inofin Incorporated, David Bergers, the director of the SEC's Boston Regional Office, issued similar comments. See Press Release, Sec.& Exch. Comm'n, SEC Charges Subprime Auto Loan Lender and Executives with Fraud (Apr. 14, 2011), available at www.sec.gov/news/press/2011/2011-92.htm ("Whether selling stock or notes, public and private companies alike must play it straight with investors for be held accountable for their misconduct.").

[6] *See*, e.g., *Sec. & Exch. Comm'n v. Inofin, Inc.*, No. 11-cv-10633-DJC (D. Mass. filed Apr. 14, 2011) (charging privately held company and several officers with violations of Section 10(b) and Rule 10b-5 for allegedly making material misrepresentations about the company's financial performance, business activities, and use of investor funds in connection with the offer and sale of unregistered securities); *Sec. & Exch. Comm'n v. C. Paul Sandifur, Jr.*, No. 05-cv-1631-JCC (W.D. Wash. filed Sept. 22, 2005) (charging officers of a privately held corporation with violations of Section 10(b) and Rule 10b-5 for the alleged fraudulent scheme to mask the corporation's deteriorating financial conditions); *Sec. & Exch. Comm'n v. Chidwhite Enter., Inc.*, No. 01-cv-131-SS (W.D. Tex. filed Feb. 28, 2001) (charging a private company and its CEO and sole shareholder with violations of Section 10(b) and Rule 10b-5 for allegedly defrauding investors in connection with an unregistered internet offering of "free" stock credits).

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