On December 12, 2011, the Securities and Exchange Commission (SEC) charged Stiefel Laboratories Inc. (Stiefel) and its former CEO and chairman with defrauding company employees and other shareholders out of over $110 million collectively in stock repurchases under the company’s employee stock bonus plan prior to the sale of Stiefel to GlaxoSmithKline plc. The SEC’s complaint alleges that Stiefel and its former CEO and chairman violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The SEC action was presumably sparked by ongoing litigation brought by ex-employees in federal district court in Florida.

The buybacks took place from November 2006 to April 2009, a time when senior management was courting various investment proposals from potential acquirers and private equity firms. While it is not surprising that Stiefel did not reveal these negotiations to employees, given the need for confidentiality in discussions, Stiefel did apparently open itself up to risk by continuing its prior practice of buying back the shares of former employees at prices substantially below the amounts discussed with potential investors and acquiring parties. Moreover, it is alleged that at one point employees were urged to sell their shares back to the company so that a larger percentage of the total equity value could be paid to the controlling shareholders in a sale of the company.

Under the employee stock plan, Stiefel determined the price it would pay current and former employees for stock buybacks based on valuations made by a third-party accountant as of the company’s fiscal-year end. The company apparently did not inform the third-party accountant of the offers and valuations the company received from the various investment firms. The company then applied a thirty-five percent discount to the valuation supplied by the third-party accountant, presumably to reflect the lack of a liquid market for the shares. The company allegedly failed to disclose the discount to selling stockholders.

As the case has not concluded, it is too early to determine what actually took place. As written, however, the SEC complaint illustrates some of the problems of stock buyback programs that are based on what purports to be a fair market value standard. Such plans are fraught with potential liability for the issuer if it has material undisclosed information that would bear on the accuracy of the valuation. Moreover, the company cannot rely on a third-party valuation if it withholds information from the evaluator or applies additional discounts, for whatever reason.
Buybacks at or around the time a company offers itself for sale are especially risky. If a private company is in fact in the midst of selling itself, it generally will not want to disclose this fact until the deal is consummated and it will, in any event, need to control the information flow during the sales process. Maintaining a buyback program under these circumstances is highly inadvisable for a private company, just as it would be for a public company. Furthermore, conflicts of interest are always a concern as majority shareholders may wish to squeeze out the minority prior to a sale of the company. Private equity investors and other acquiring parties should also look out for this potential liability in the companies that they purchase.

Bonnie J. Roe is a partner in the Corporate Group of Cohen & Gresser LLP where she represents publicly and privately held companies and investment funds. Andrew M. Por is an associate in the Corporate Group of Cohen & Gresser LLP.