Of Broken Leases and 'Broken Windows'

BY MICHAEL S. DICKE

Fenwick
FENWICK & WEST LLP

On Dec. 3, 2014, the Division of Enforcement of the U.S. Securities and Exchange Commission brought an enforcement action against two former top executives of Assisted Living Concepts LLC, a large provider of senior living residences based in Wisconsin, alleging the executives had schemed to hide ALC's breach of a lease covering several of its more than 200 facilities.[1]

According to the SEC Division of Enforcement's order instituting proceedings ("order"), when former CEO Laurie Bebo and former Chief Financial Officer John Buono realized that ALC was not maintaining a contractually required level of resident occupancies in a few of its senior facilities, which could have allowed its landlord to declare a lease default and pursue liquidated damages, they directed accounting personnel to inflate resident counts in documents ALC provided to the landlord.

The SEC claims that Bebo and Buono fooled the landlord by listing ALC employees and fabricated individuals as senior residents to boost reported occupancies. Further, the SEC claims that Bebo and Buono signed audit certifications given to ALC's independent audit firm where they falsely attested that ALC was in compliance with all contractual agreements.

Significantly, while the SEC's blaring headline announcing the case — "SEC Announces Fraud Charges Against Two Executives in Scheme Involving Fake Occupants at Senior Residences" — suggests that ALC somehow fraudulently inflated its publicly reported financial numbers, it did not.[2] Indeed, the SEC's order makes clear that while ALC included quarterly revenue for the allegedly "fake" residents in documents it gave its landlord, it later reversed that revenue and did not include such revenue in its SEC filings or in other public statements.

Instead, the SEC's fraud claim rests upon the allegation that ALC's periodic filings were materially misleading to its investors because the company falsely represented in its 10-Ks and 10-Qs that it was in compliance with the lease covenants, and failed to properly disclose a loss contingency after it triggered the lease default provisions.

Seen as a fraud case, the SEC's allegations seem a bit of a stretch, turning what is foundationally a breached contract into a full-blown Section 10(b) securities fraud claim. As the SEC order notes, the lease at issue covered only eight out of more than 200 facilities run by ALC, and thus it is not at all clear that investors would have cared if ALC breached the lease and became subject to accelerated payment terms.

But seen as a case about top executives deliberately creating false corporate documents and lying about it to the auditors, then the ALC case fits perfectly into the SEC's "broken windows" strategy of focusing not just on revenue recognition and other traditionally fraudulent accounting practices, but instead also on disclosure issues and more isolated transgressions.[3] And the ALC case serves as a reminder that creating false company documents — even if those actions have no effect on reported revenues, profits or other key financials — can have perilous results for the individuals involved.

Indeed, the SEC alleges that Bebo and Buono violated the anti-fraud, books and records, lying to auditors, and other provisions of the federal securities laws, and seeks (among other remedies) officer and director bars, monetary penalties, and a bar against Buono appearing or practicing as an accountant before the SEC.

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1 *In the Matter of Laurie Bebo, and John Buono, CPA, Exchange Act Release No. 73722, 2014 WL 6805491 (Dec. 3, 2014).*

2 *See SEC press release, available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543576909.

3 *See Speech by Mary Jo White at Securities Enforcement Forum discussing the Broken Window approach to enforcement matters, Oct. 9, 2013, available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.VEwNovnF98E.

The Scheme to Deceive ALC's Landlord and Avoid Triggering Default of the Lease Covenants

Between 2009 and 2012, ALC was a steadily growing, New York Stock Exchange-traded operator of senior living residences, operating more than 200 facilities totaling more than 9,000 units, according to the SEC's order. To further expand, in 2008, ALC acquired the operations of eight senior facilities from Ventas Inc., a real estate investment trust with a large portfolio of senior residential properties.

ALC simultaneously entered into a lease with Ventas to operate the facilities, agreeing in the lease to a number of financial covenants. These provisions required ALC to submit to Ventas documents quarterly showing that ALC was maintaining at least 65 percent occupancy at each Ventas facility, as well as meeting-related financial metrics.

A year later, ALC was falling short of the occupancy requirements. In an attempt to make up the shortfall, Bebo asked ALC's general counsel if ALC's occupancy calculations could include corporate employees who sometimes stayed overnight at the senior residences. The general counsel advised that Ventas would have to agree to such a practice. Instead of seeking Ventas' ascent (presumably because Ventas would not have agreed), Bebo and Buono began not only secretly including ALC employees in the residency count, but also listed friends, family and later, fabricated individuals, in the count.

The SEC's order details the elaborate steps that Bebo and Buono allegedly took at the end of each quarter from 2009 to early 2012 to create the false documentary evidence ALC needed to convince Ventas that ALC was in compliance with the covenants.

For instance, ALC personnel reverse-engineered the exact number of nonresidents necessary to meet the quarterly lease requirements, and Bebo then listed out the identities of the nonresidents that ALC would include in the documents given to Ventas. ALC personnel then prepared monthly journal entries for each leased facility that recorded purported revenue associated with the nonresidents' inclusion in the financial covenant calculations, and then reduced revenue by the same amount in a corporate revenue account. (Note that these offsetting entries ultimately meant that ALC's overall reported revenues and net income would not be affected). Buono signed certifications attesting to the accuracy of the information that ALC provided to Ventas.

Bebo and Buono also signed false certifications to ALC's outside auditors by attesting that ALC had complied with all contractual agreements that would materially affect ALC's financials, according to the SEC's order. Further, the SEC claims that even after an ALC employee complained to them that inclusion of the nonresidents in the financial covenant calculations may be fraudulent, Bebo and Buono lied to the outside auditors by falsely attesting that they had no knowledge of any fraud allegations involving ALC.

Further, the SEC alleges that Bebo and Buono knew, or were reckless in not knowing, that ALC's periodic SEC filings contained the false representation that ALC was in compliance with the financial covenants in the Ventas lease, and also falsely represented that ALC was unlikely to breach the covenants. Further, the order claims that Buono knew, or was reckless in not knowing, that ALC failed to disclose a loss contingency associated with ALC's violation of the lease covenants, pursuant to Accounting Standards Codification ("ASC") 450-20-50-3.

According to the SEC's order, the scheme came to light during settlement discussions as part of a lawsuit filed by Ventas against ALC over issues unrelated to the financial covenants. Eventually, as part of a settlement, ALC purchased from Ventas the eight facilities at issue. In July 2013, ALC was sold to a private equity firm and its shares ceased public trading.

Was ALC's Representation in its SEC Filings That It Was in Compliance with the Lease Terms Material?

Among other elements, to prove its fraud claims against Bebo and Buono, the SEC Division of Enforcement must show that ALC's statement in its 10-Ks and 10-Qs that ALC was in compliance with the Ventas lease covenants was material to a reasonable investor, or that material information about compliance with the lease was omitted.

To show materiality, the SEC relies heavily on the fact that in the event of a breach of the lease, Ventas could

require ALC to pay damages equal to the unpaid rent for the remaining term of the lease, which would have amounted to "101%, 81%, and 46% respectively of ALC's income from operations before income taxes" for 2009, 2010 and 2011. The key word is could.

Such a contract provision certainly gives Ventas the option of filing a suit seeking such damages, but it is unclear if Ventas would invoke that provision, or that a judge or jury ultimately would order that remedy. Suing to enforce a contract is costly, invites counter-claims, and leaves one to the whims of a judge or jury. Given the speculative nature of a contractual damages clause like this, and given that the Ventas facilities were a small part of ALC's vast operations, ALC certainly has an argument that breaching the Ventas lease was not a material event.

The SEC's Primary Focus: Falsified Documents and Misstatements to Auditors

While the claim that ALC deceived its investors about material facts may prove to be a stretch, the rest of the SEC's detailed allegations show that the case fits squarely in line with the SEC's zero-tolerance "broken windows" approach to corporate officers and gatekeepers who alter records and deceive the company's independent auditors.

For instance, on Oct. 15, 2014 the SEC Enforcement Division brought charges against a former Wells Fargo Advisors compliance professional for allegedly altering a key company document before it was produced to the SEC enforcement staff.[4] Less than a month earlier, the SEC settled charges with Saba Software, a Silicon Valley software company, based on allegations that its managers directed professional services consultants in India to alter time recorded on projects for Saba's customers.[5] Finally, in July 2014, the SEC brought charges against the former CEO and CFO of QSGI Inc. for creating false corporate documents, filing inaccurate certifications of internal controls, and misleading the outside auditors.[6]

For corporate officers — especially those who are gatekeepers such as accountants or lawyers — the remedies the SEC can obtain for violation of the books and records and misstatements to auditors rules can have devastating career consequences. For instance, in 2012, the commission considered the appropriate sanction for a corporate controller found to have altered corporate records for stock option grants and then lying to the auditors about such actions.[7] The commission emphasized that because accurate books and records are one of "'the bedrock elements of our system of corporate disclosure,'" a corporate officer who intentionally creates false documents "betray[s] these principles."[8] The commission imposed a permanent bar under SEC Rule 102(e) prohibiting the respondent from appearing or practicing before the commission.[9]

Conclusion

Even where a company's publicly reported financials are unaffected, or misconduct is isolated to a small segment of an issuer's business, expect the SEC nevertheless to continue focusing on cases involving corporate executives who alter documents or hide information from audit scrutiny.

Mike Dicke is a litigation partner at Fenwick & West in San Francisco and co-chairman of the firm's securities enforcement group. Until October 2013, he was the associate regional director for enforcement in the SEC's San Francisco Regional Office.

4 In the Matter of Judy K. Wolf, Exchange Act Release No. 73350, 2014 WL 5199201 (Oct. 15, 2014).

5 In the Matter of Saba Software Inc., Patrick Farrell and Sajeev Menon, Exchange Act Release No. 73200, 2014 SEC LEXIS 3595 (Sept. 24, 2014).

6 In the Matter of Marc Sherman, Exchange Act Release No. 72723, 2014 WL 3735560 (July 30, 2014), and In the Matter of Edward L. Cummings, CPA, Exchange Act Release No. 72722, 2014 WL 3735559 (July 30, 2014).

7 In the Matter of Michael C. Pattison, CPA, Exchange Act Release No. 67900, 2012 WL 4320146 (Sept. 20, 2012).

*8 Id. at *8 (quoting SEC v. World-Wide Coin Inv. Ltd., 567 F. Supp. 724, 746 (N.D. Ga. 1983)).*

*9 Id. at *12.*