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MVA Litigation Client Advisory
August 2017

Timely Disclosure of Investigation Loss Contingencies: The SEC's Aggressive Enforcement Stance

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In *SEC v. RPM International, Inc.*, No. 16-01803 (D.D.C. filed Sept. 9, 2016), the SEC has pushed its aggressive litigation strategy in pursuit of its policy of compelling registrants to accelerate loss contingency disclosures. The SEC filed the action under sections 17(a)(2) & (3) of the 1933 Act, sections 13(a) & (b)(2) of the 1934 Act, and the corresponding 1934 Act rules. The SEC filed against RPM International, Inc. and its general counsel, Edward Moore, alleging the failure to disclose a material loss contingency and record an accrual as a result of the filing of a *qui tam* complaint against RPM and a subsidiary and a resulting Department of Justice investigation.

The SEC alleges Moore committed fraud and RPM also committed fraud based upon his conduct—which primarily involves his not disclosing the key facts of the claim to others at RPM or its auditors. The SEC alleges also RPM committed fraud by failing to disclose a material weakness in its internal controls for loss contingencies after it learned the facts. *RPM International* doubles down on the SEC's effort to require earlier disclosures of loss contingencies based upon internal evaluations without waiting for the classic internal triggers of a government demand or notice of a pending action by the government. This strategy calls into question shorthand rules about disclosure that have been guided many practitioners the practice for years.

RPM and Moore filed separate motions to dismiss the SEC's complaint in February 2017. Briefing on the motions to dismiss was completed this May. It is unclear when the court will rule.

FACTS

The defendants first learned of DOJ's investigation in March 2011 when RPM's subsidiary Tremco received a DOJ subpoena requesting documents related to the allegations made in the *qui tam* filing. RPM hired counsel immediately. DOJ did not provide RPM a copy of the *qui tam* complaint until August 2012 and in September Mayer Brown, RPM's counsel, met with DOJ and admitted Tremco had overcharged the federal government by at least $11.4 million in violation of the False Claims Act ("FCA"). By December 2012, RPM's counsel, with Moore's authorization, updated DOJ with an estimate of $11.9 million in overcharges and disclosed the total likely would

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continue to rise. The following month, RPM made a first settlement offer to DOJ of $28.3 million. In March 2013, DOJ countered at $71 million. Ultimately, RPM settled with DOJ for $61 million in August 2013.

RPM's GC Moore disclosed the DOJ subpoena to the Board's Audit Committee and its auditor in April 2011. However, RPM did not disclose the DOJ investigation in its SEC filings or accrue a liability until April 2013.

One year after settling, in August 2014, RPM restated its financial results for the three quarters after March 2011 to incorporate loss contingency accruals for each quarter. In the restated filings, RPM acknowledged errors relating to the timing of its disclosure and accruals for the DOJ investigation, but stated these were errors, not fraud or other misconduct.

ACCOUNTING GUIDANCE: GAAP and IFRS STANDARDS

For GAAP users, Accounting Standards Codification 450 codifies generally accepted accounting principles with respect to loss contingencies. ASC 450 defines a "loss contingency" includes: (1) actual or possible claims and (2) pending or threatened litigation. Under ASC 450-20-50-3, disclosure of an asserted loss contingency or claim is required if a material loss is reasonably possible, meaning likely. Probable is intended to be a higher threshold that IAS 37, and should be a higher likelihood than IAS 37's 50% rule, but ASC 450 does not give a probability number.

If the loss is "probable" and "reasonably estimable," then an accrual of liability is required. If there is a range of possible losses, the most likely should be used. If likelihood within the range cannot be assessed, the minimum should be recognized. If the loss is probable but not reasonably estimable, a disclosure is required and must indicate the amount or range of possible loss or explain why an estimate cannot be made. If a potential claim has not yet been asserted, disclosure is required only if the claim is "probable" and there is at least a reasonable possibility of an unfavorable outcome.

For IFRS users, International Accounting Standard 37 controls. IAS 37 states that a provision shall be recognized when: (a) an entity has a present obligation as a result of a past event; (b) the loss is probable; and (c) a reliable (risk adjusted) estimate can be made of the amount of the obligation. For IAS 37 probable means "more likely than not" taking into account all of the available evidence— and specifically greater than 50%. If there is a range of possible losses, the most likely should be used. If likelihood within the range cannot be assessed, the midpoint should be recognized. If a reliable, risk-adjusted estimate is not possible, the liability must be disclosed as a contingent liability. No disclosure is required in the risk of loss on the contingency is "remote."

THE SEC'S ALLEGATIONS

The SEC alleges that not later than October 2012—when RPM and Moore became aware of the *qui tam* case and gave DOJ a liability estimate—disclosure and accrual were required under ASC 450-20 because RPM and Moore knew a claim had been asserted and a material loss was probable and reasonably estimable at no less than the amount of its settlement offer. The SEC argues the accrual should have increased each time RPM gave DOJ a higher estimate of the overcharges and at each offer or counter-offer. Therefore, the SEC alleges, from October 2012 through April 2013, RPM submitted materially false and misleading filings to the SEC in violation of the antifraud sections of the Securities Act of 1933, *i.e.*, Sections 17(a)(2) and (a)(3); the reporting provisions of the Securities Exchange Act of 1934 and relevant rules thereunder, *i.e.,* Section 13(a); and the books and records and internal controls provisions of the Exchange Act, *i.e.,* Sections 13(b)(2)(A) and 13(b)(2)(B).

With respect to Moore, the SEC alleges that Moore violated Sections 17(a)(2) and (a)(3) of the Securities Act, and Rules 13b2-1 and 13b2-2 of the Exchange Act. Specifically, the SEC alleges that Moore oversaw RPM's response to the DOJ investigation, but failed to timely to disclose material facts about the investigation to RPM's CEO, CFO, Audit Committee, and independent auditors, which ultimately led to RPM's false filings. According to the SEC, Moore intentionally misled RPM's auditors throughout 2012 and early 2013 in audit responses regarding loss contingencies by telling them that he had not worked on claims asserted against RPM in excess of \$1.2 million (the auditor's threshold).

The SEC alleges the fraudulent reporting is compounded by the fact that it was not until August 2014 that RPM restated its financials and disclosed it should have accrued and disclosed sooner; thus, all filings prior to August 2014 were also fraudulent even after RPM made the initial disclosure. The SEC alleges RPM had the duty to disclose a material weakness its internal controls over financial reporting and disclosures--proven by RPM's failure to make the required accruals and disclosures timely.

The SEC argues RPM had a duty to disclose under Item 303 of Regulations S-K (MD&A disclosure of uncertainties and trends that could have a material negative impact on sales, revenue or income), Exchange Act rule 12b-20 (disclosure of information required to make other disclosures not misleading), and because its securities filings state generally that the company follows GAAP, and specifically ASC 450-20.

The SEC's posture against RPM based on Moore's alleged conduct most vividly illustrates the aggressiveness of its position. First, it argues that Moore committed fraud by hiding the facts from RPM Management, its audit committee, and its auditors. Having it both ways, the SEC then argues RPM is liable because Moore fraudulently withheld the critical information while acting within the scope of his authority.

The SEC alleges Moore hid the facts most obviously when, in response to audit letters, he represented that "since June 1, 2012, neither [he], nor any of the lawyers over whom [he] exercise[d] general legal supervision, [gave] substantive attention to, or represented [RPM] in connection with, material loss contingencies" in excess of \$1.2 million. In fact, the audit response goes on to state "except for the matters described in the audit response letters of the law firms listed in Exhibit A," and "Exhibit A" listed Mayer Brown as representing RPM in connection with "Tremco Roofing Matters," the subject of the DOJ investigation. The SEC's position is shown to be highly aggressive, but not disingenuous by the fact that outside counsel took the standard position in its audit responses that it did "not consider investigations by government or self-regulatory author ities to fall within the definition of 'loss contingency.'" Thus, Moore can be accused of arbitraging the law firm's response to hide the loss contingency. The SEC alleges a number of motives for Moore's keeping the facts secret, including that fact that in response to two other extraordinary one time charges in the Fall of 2012 the Audit Committee informed Management it would not be tolerant ongoing extraordinary charges and preservation of his bonus.

THE DEFENDANTS' RESPONSE

In support of its motion to dismiss, RPM argues that it had no legal duty to disclose or accrue for before April 2013 there was no asserted claim until DOJ gave notice it would pursue the *qui tam* case. Further, ASC 450 does not require disclosure of *contemplated* settlement offers and ASC 450 offers no objective guidance when a claim becomes "asserted" or a liability becomes "probable" or "reasonably estimable." Thus, RPM argues that any decision to disclose was a subjective decision and matter of opinion, not fact; and, therefore, the SEC had to allege RPM's statements were *subjectively* false. RPM further argues that any alleged misrepresentations were immaterial because its disclosure and accrual did not negatively impact its stock price.

Similarly, Moore argues that a material loss was neither probable nor reasonably estimable until DOJ responded to RPM's overcharge analysis or indicated it would intervene in the *qui tam* action. Moore also argues that the applicable standard of care in Section 17(a)(2) and (a)(3) for claims alleging negligence is "reasonable prudence," and that the SEC did not plead he failed to exercise reasonable prudence on a complex accounting issue with little clarity in the literature. Finally, as noted above, Moore argues that he did not mislead auditors because his communications to them stated that he had not worked on a material matter *except as disclosed by company's outside counsel*.

The SEC response leans heavily on the argument that when RPM's August 2014 restatement acknowledging errors in the timing and accrual of the contingency was an admission the facts the SEC must prove to establish liability. RPM replies in made the August 2014 restatement only because its auditor compelled it to do so. The SEC argues also that Moore had the duty to obtain accounting guidance on ASC 450-20 and by failing to do from the Management and auditors he acted fraudulently.

LESSONS LEARNED

The SEC is pushing its agenda of requiring companies to make earlier disclosure of loss contingencies based upon their internal evaluations, privileged or not, without waiting for an external trigger. The SEC relies on the LIBOR and FX investigations, in which financial institutions made disclosure of the investigations and possibility of material financial and reputational harm long before they had firm estimates of any potential government or private liabilities. The SEC appears to be trying to cement and accelerate this perceived practice shift.

There is precedent for the SEC's position when a company is making settlement offers that contradict public disclosures, but the disclosures typically have been much more specific about company strategy and the contrast with settlement negotiations stark. *See, e.g.*, *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.,* 185 F. Supp. 2d 389, *recons. den.*, 207 F. Supp. 2d 292 (S.D.N.Y. 2002). Here the SEC is taking a more aggressive approach relying on general statements by RPM that many would deem not be specific enough to trigger disclosure obligations. A number of cases hold general statements about accounting practices are too general to support a securities fraud claim. *See, e.g., In re Hansen Natural Corp. Sec. Litigation*, 527 F. Supp. 2d 1142, 1148, 1152-54 (C.D. Cal. Oct. 16, 2007); *City of Austin Police Ret. Sys. v. ITT Educ. Servs., Inc.*, 388 F. Supp. 2d 932, 946-48 (S.D. Ind. 2005).

Our reading of the case is that the district court will deny the motions to dismiss. Regardless of the court's ruling, the SEC's aggressive posture has to be taken into account when considering making a disclosure. Companies must regularly evaluate their accounting and disclosure controls. Transparency between executives, auditors, counsel, and internal finance and accounting is important and privilege will have to be managed carefully. Companies must tune in to the ASC 450-20 analysis. The SEC is demanding reconsideration of a number of the shorthand rules that justified non-disclosure of investigations or their underlying facts, such as no disclosure is required until after the government makes clear its intent to file imminently.

If you have any questions about or would like to discuss this Client Advisory, please contact James P. McLoughlin, Jr. or Neil T. Bloomfield in Moore & Van Allen's White Collar, Regulatory Defense, and Investigations team.