COVERING THE CASE LAW OF BROKERAGE HOUSE DISPUTES Vol. 2012 • No. 1

SECURITIES LITIGATION COMMENTATOR

SLAs 2012 | 1-6 • PUBLISHED 9/12 ISSN: 1557-6019

THE CROSS-HAIRS OF ACCOUNTING AND LAW: THE VECTORS OF LITIGATION RISK

By Norman B. Arnoff and Paul I. Immerman***

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The Cross-Hairs Of Accounting And Law: The Vectors of Litigation Risk

By Norman B. Arnoff and Paul I. Immerman***

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a work in progress. The legislative intent is to recapture by more effective concentration on specific and inherent risks -- as well as more effective coordination among regulators -- the transparency and market integrity lost over the last number of years. There also should be additional methods of addressing and avoiding systemic risks.

Consonant with that is the subject of this article, which is the enhancement of professional responsibility and the necessary coordination of different disciplines when overlapping issues arise in the respective engagements of accountants and lawyers.

In the public or private offering context, law and accounting issues become intertwined in highly challenging ways that present to both professions the difficult objectives of not only making the correct analysis in terms of their own professional discipline, but of their colleague's discipline as well, so that there is the required transparency. This clearly is essential for the company making a securities offering, whether it is a public or private offering. The capital-raising function cannot be impaired and, therefore, the broadest disclosure is mandated.

To avoid the debilitating threat of litigation costs and regulatory sanctions, the better approach is to make a careful accounting and legal analysis that requires the sophistication and sensitivity of both the legal and accounting professions and the less costly premiums of complete and material disclosure in all documents given to investors and lenders or filed with the regulators. Above all, sound preventive measures must be taken to avoid costly and protracted securities litigation.

Accounting For Litigation Uncertainties

Coordination among litigation and corporate counsel and the company's accountants in the context of determining contingent liabilities from threatened or pending litigation offers an excellent template for illustrating the opportunities that exist for these professionals to not merely do their jobs, but to serve their corporate client and public investors by advancing market integrity and transactional transparency. Particularly with large securities class actions and other complex litigation, the need to weigh the risks of an unfavorable outcome, to disclose the nature and probabilities of litigation risks, and to quantify those risks for reserve purposes provide the professional with considerable challenges and, at the same time, tantalizing prospects to serve well.

The Professional Accounting Standards

Both FAS5: Accounting For Contingencies, promulgated in 1975 by the Financial Accounting Standards Board ("FASB"), and FASB's promulgation in July 1, 2009 of the Accounting Standards Codification ("ASC") 450 provide the starting points for analysis when contingent liability issues arise in the litigation context.

FAS5 states, "a contingency is defined as an existing condition, situation, or set of circumstances involving *uncertainty* as to possible gain... or loss... to an enterprise that will ultimately be resolved when one or more future events occur or are likely to occur... *When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote*... [T]he terms probable, reasonably possible, and remote identify three areas within that range...." (Emphasis Added).

"Pending or threatened litigation" and "actual or possible claims and assessments" are two of the uncertainties where the fundamental distinctions between

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probable, reasonably possible and remote must be given more precise definition and application in the financial reporting process in respect to the accrual of the loss contingency, i.e., reporting it as a liability.

FAS5 provides that "[a]n estimated loss from a loss contingency... shall be accrued by a charge to income if ... information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability had been incurred at the date of the financial statements... [and] [i]t is implicit in this condition that *it must be probable that... future events will occur confirming... the loss...* {Additionally} [t]he amount of loss can be reasonably estimated… {in respect to an accrual}." (Emphasis Added)

FAS5 further provides:
"Disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred…. *Even if an accrual is not made…, [t]he disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made*." (Emphasis Added)

Further "disclosure is *not* required as to a loss contingency involving an unasserted claim or assessment when there has been *no* manifestation of a potential claim or assessment... [or] an awareness of... [the] possible claim or assessment *unless* it is considered probable that a claim will be asserted *and* there is a reasonable possibility that the outcome will be unfavorable." (Emphasis Added)

In other words, disclosure is required when there is a probability that the claim will be asserted and the reasonable possibility exists of an unfavorable outcome in the period covered by the financial statement. The disclosure is triggered by the "reasonable possibility" of an unfavorable outcome. While "probable" is the standard for liability determinations, disclosure of litigation risks is still appropriate when there is no basis for accrual but there still remains a sufficient threshold of risk.

Disclosure has to take place in virtually all circumstances except when the possibility of liability is remote. FAS5 also sets forth the qualification that the mere "filing of a suit or formal assertion as a claim or assessment does not automatically indicate that the accrual of a loss may be appropriate."

ASC 450 does not substantially amend FAS5. It merely clarifies it. Whether the governing professional standard was or is FAS 5 or ASC 450, accrual of a liability would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of the financial statements but before those financial statements are issued. Disclosure, however, in this context is appropriate.

Accrual may be appropriate for litigation, claims, or assessments whose underlying

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cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statement. This may seem nonsensical, but, unlike the immediacy of public disclosures, financial statements are historical renderings, prepared well after the fact and published with the facility and advantage of hindsight. Often, that hindsight is informed by revelations arising after the date of the financial statement.

Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment.

A decision to contest the case vigorously or a decision to seek an out-of-court settlement will affect whether the liability is to be accrued or merely disclosed. The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss is met.

With respect to unasserted claims and assessments, an enterprise and its professional advisers must determine the degree of probability that a claim may be asserted and the possibility of an unfavorable outcome. An investigation of an enterprise by a regulatory authority such as the SEC is an excellent example of when disclosure is not only required but accrual may be prudent.

If the judgment is that the assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required. If an amount of loss *cannot* be reasonably estimated, accrual is *not* appropriate. Disclosure is nonetheless appropriate and more likely than not the soundest course. The disclosure, however, should be grounded in the true facts and applicable law and not merely be a mechanical application to avoid professional liability and liability to the board and management.

The Cases And The Law

Accounting standards that deal with litigation uncertainty are easily stated. The challenge is in the application and the variables that come into play in order to distinguish what is probable from what is reasonably possible, and whether the liability or possible liability can be reasonably estimated. Those standards, however, when interpreted and applied in the context of litigation or its anticipation, can be informative tools, both to defend against and to prevent liability in securities and professional liability litigation.

In *SEC v. Guenther*[1], the Court held: *"... to give rise to section §10(b) liability for fraud, the mere second-guessing of calculations will not suffice; the Commission must show that the defendants' judgment - at the moment exercised - was sufficiently egregious that a reasonable accountant reviewing the facts and figures should have concluded that the company's financial statements were misstated and that as a result the public was likely to be mislead. (Emphasis Added)*

"GAAP and the anti-fraud rules promulgated under §10(b) of the 1934 Act serve similar purposes, and courts have often treated violations of the former as indicative that the latter were also violated.... Nevertheless, the prohibitions contained in the GAAP and in section 10(b) are not perfectly co-extensive. In some circumstances, courts have found defendants liable for securities fraud under §10(b), despite having complied with GAAP, while in other circumstances, courts have discharged defendants from §10(b) liability, notwithstanding deliberate violations of GAAP."

Discretionary judgment is a constant in dealing with litigation uncertainty and therefore there is a relatively high bar to establish professional and civil liability. The *Guenther* Court recognized, where there is litigation uncertainty, an easy to overcome threshold in order to accrue a liability does not exist. The Court held: "'GAAP is a term of art that encompasses a wide range of acceptable procedures…. GAAP are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions…. [GAAP] rather tolerates a range of 'reasonable' treatment, leaving the choice among alternatives to management. *Accounting concepts are flexible, {and} circumstances will give rise to fraud only where differences in calculating are the result of a falsehood, 'not merely the difference between two permissible judg-*

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ments'.... A reasonable accountant may choose to apply any variety of acceptable procedures when preparing a financial statement...." (Emphasis Added)

This forgiving professional judgment rule[2], however, is not an absolute shield from liability. What cannot and should not be disregarded is that disclosure is virtually always prudent, even when the facts and circumstances would not require it because the possibility of litigation and a successful claim being asserted is remote.

The possibility of falsity and material omission necessitates an evaluation of the total mix of information before liability can be adjudged. The Court held in the cited case: "A misinterpretation is considered 'material' if it has been established there is a substantial likelihood that the misrepresentation would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available…. A determination of materiality requires delicate assessments of the inferences that a reasonable shareholder would draw from a given set of facts and the significance of those inferences to the shareholder…. Although materiality generally presents a factual question, the issue may be decided as a matter of law in an appropriate case upon a showing that 'a reasonable investor could not have been swayed by an alleged misrepresentation, or omission.' *Cautionary language that relates directly to the issue on which plaintiff claims to have been misled can render the alleged misrepresentation or omissions immaterial as a matter of law…"* (Emphasis Added)

The *Guenther* case also stands for the proposition that expert testimony is necessary to inform the adjudicator of the facts with respect to the interpretation and application of professional standards. Qualified experts, however, are not permitted to opine upon ultimate issues that usually are conclusions of law. Issues such as whether the defendant aided and abetted any breach of fiduciary duty by the officers and directors of the issuer are good examples. The latter is both an ultimate legal issue and beyond the scope of expert opinion.

PEC Solutions Inc. Securities Litigation[3] was a class action involving securities fraud allegations, premised upon accounting fraud. The Court held not only was particularity required in the pleading in order to survive a motion to dismiss, but that the allegations of misrepresentations are to be addressed in terms of the totality of the facts, i.e., "'*a court should not consider each relevant factual allegation solely in isolation…, but rather as a part of the overall factual picture painted by the complaint*." (Emphasis Added)

Not only must the total mix of information be considered but it is also a settled proposition that violations of accounting standards are not in and of themselves violations of the anti-fraud provisions. Further misstatements and omissions are not actionable when they are not considered "material because in light of the quality of the company's disclosures, any additional disclosures could not have altered the 'total mix' of information available to an investor."

Moreover, in respect to litigation uncertainty there is a threshold of required predictability and certainty when a liability should be accrued. The Court in *Alphastar Insurance Group Limited et al. v. Arthur Anderson et al.*[4] held: "… the defendants could not have misrepresented the likely outcome of the … litigation because the outcome could not have been predicted with the type of likelihood required by F.A.S.5."

Neither general fraud allegations nor allegations of accounting violations, without more, constitute sufficient allegations of accounting fraud. In *Local 295/Local 851 Employer Group Pension Trust v. Fifth Third Bancorp,*[5] the Court held, however, accounting violations can be indicative of fraud. Specificity is not merely required to state the nature of the error but its magnitude as well. The Court held: "Accounting violations, standing alone, do not create an inference of *scienter*…. If however, the accounting errors are sufficiently basic and large, their existence in combination with other factors may support the requisite *scienter* …. '*In order to establish scienter based on accounting violations..., the complaint must allege 'extreme' in your face facts that 'cry out scienter.*'" (Emphasis Added)

The Court also recognized "'the estimation of probable losses in a large loan portfolio is more of an art than a science'…. Indeed the complaint cited … different standards or accounting authorities that address accounting for loss contingencies, much of which in turn contain numerous subparts or considerations.…"

In *Biver County Retirement BD v LCA Vision Inc..,*[6] the Court held in order to be sufficient to give rise to an inference of *scienter "'…[the] allegations of accounting violations… [have to be]… so simple, so basic and pervasive in nature, and so great in magnitude, that they should have been obvious to a defendant*." (Emphasis Added) The accounting violations were not "'so simple, basic, or pervasive in nature'" as to be obvious to the defendant.

In *NVIDIA Corporation Securities Litigation,*[7] the Court addressed in the context of a securities class and fraud action the two key issues that must be resolved before a liability can be accrued. Not only must there be 'probable loss' but the accounting charges must be "'reasonably estimable' before the end date of the period covered by the financial statement.

Further, if the violation of accounting standards are to have any probative value the allegations, especially where the Private Securities Litigation Reform Act ('PSLRA') is applicable, must have specific and concrete content coupled with the allegation of knowledge or reckless disregard by the wrongdoer that the error will have a material impact on the financial statement and as a result make a likely difference to the investor in regard to his or her investment decision. Nor is there a more liberal standard of pleading or proof for the SEC when it brings enforcement actions."[8]

Conclusion And A Further Recommendation

Accounting for litigation uncertainty takes lawyers and accountants to a professional intersection that can have serious, unintended consequences unless FAS5 and ASC 450 are understood. This is true in terms of how they are interpreted and

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applied as an accounting standard in the financial audit and reporting process, as well as to what legal effect these standards are to be given by the courts. *The standards are clear in principle but difficult to apply and therefore require clear, sensitive, and cooperative communication between the legal and accounting professions. An interactive dialogue is not only a means to avoid the pitfalls of professional liability but most importantly best serve the client*.

When an event may be reasonably possible to result in a liability, it must be disclosed. When it is probable and reasonably estimable in amount, a liability is accrued if such an event took place within the fiscal year. However, that is not the end of the story. The law is forgiving with respect to professional and civil liability, because in this context the judgment of both the legal and accounting professions must address complex, sensitive and difficult questions. It should be recognized the only real liability exposure occurs when there is a failure to disclose material facts, so opting for disclosure is a given.

Some will view such disclosure as an invitation to litigation. However, non-disclosure can be an even stronger precipitating factor to cause litigation. Again it is good to remember what Justice Louis Brandeis said in this context, i.e., "*sunlight is the best disinfectant*" and that precept, which should be internalized by the members of both professions, is the best means both to avoid professional and civil liability and to best serve the client and the investing public. Accurate and material disclosure on an ongoing basis is always the soundest and best professional advice to be given, as well as the safest way to avoid the systemic risks that inhere in the professional practices of both lawyers and accountants.

■

END NOTES

1. 395 F.Supp.2d 835, Fed. Sec. L. Rept. P 93,512 (U.S.D.C. Nebraska. 2005)
2. Baltimore Associates LLC v. Thimmesch, 2007 WL 5662124 (U.S.D.C. Arizona. 2007); In re; K-Tel International Inc. Securities Litigation 107F. Supp 2d 994 (U.S.D.C. Minnesota 2000)
3. 2004 WL 1854202 (E.D. Va. 2004)
4. 383 B.R. 231 (US Bankruptcy Court SDNY 2008)
5. 731 F. Supp 2d.689 (U.S.D.C. Ohio, Western Division 2010)
6. 2009WL806714 (U.S.D.C. S.D. Ohio 2009)
7. 2010WL4117561 (U.S.D.C. N.D. Cal 2010)
8.SEC v. Leslie, 2012WL116562 (U.S.D.C. N.D. Cal 2012)

OUT OF THE FIRE, INTO THE FRYING PAN.

Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, must have considered themselves lucky when they were found not guilty of securities fraud in a criminal trial. Prosecutors in that case accused the two of giving rosy forecasts for the performance of the hedge funds that they knew were on the verge of collapse. However, the two did not escape unscathed by any means; the SEC pursued a civil proceeding against them and reached a settlement in which Cioffi and Tannin, while not admitting to any liability, agreed to be barred from the securities industry for three years and two years, respectively, and to pay a total of $900,000 in disgorgement and $150,000 in penalties. (NOTE: For a summary of the Court's approval of the settlement, with further details on the background of the case, see SLA 2012-26.)

Source: "Ex-Bear Stearns Managers To Settle SEC Suit For $1M," by Lana Birbrair, www.law360.com (2/13/12).

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