King & Spalding

Client Alert

Corporate Practice Group
Securities Litigation Practice Group

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SEC Files Action Against Company and its General Counsel for Loss Contingency Accrual and Disclosure Failures – What to Know

SEC's Factual Allegations

On September 9, 2016, the Securities and Exchange Commission ("SEC") filed a complaint against RPM International Inc. ("RPM") and its General Counsel and Chief Compliance Officer, alleging the company failed to properly accrue for and disclose material facts about a contingent loss involving a Department of Justice ("DOJ") investigation, which ultimately resulted in a $61 million False Claims Act ("FCA") settlement with the government. *See SEC v. RPM Int'l Inc.,* U.S.D.C. District of Columbia, No. 1:16-cv-01803. The SEC alleges that RPM's General Counsel failed to disclose to RPM's CEO, CFO, audit committee, and independent auditor key updates about the investigation and the *qui tam* suit from which it arose. The complaint alleges that as a result, the company failed to timely accrue for and disclose the potential liability.

In 2010, the DOJ began investigating a subsidiary of RPM after a former employee filed a *qui tam* complaint alleging that the subsidiary had overcharged the federal government on certain contracts in violation of the FCA. RPM became aware of the investigation in March 2011 upon receiving a subpoena. While the General Counsel did discuss the existence of the subpoena with company officers and directors and the company's independent auditor in April 2011, the SEC alleges that he failed thereafter to disclose key details about the investigation and the status of settlement talks, including the fact that the DOJ had shared the partially unsealed *qui tam* complaint.

According to the SEC's complaint, an internal investigation by RPM discovered overcharges of at least $11 million by September 2012 (which was shared with the DOJ) and around $27-28 million by December 2012, which led to a $28 million settlement offer to the DOJ in January 2013. Yet, the SEC alleges RPM's General Counsel did not share these estimates with key individuals, including the CEO, until one day before the settlement offer, and did not share them with the CFO, audit committee, and independent auditors until after the settlement offer was made. During this period, no accrual was recorded and no disclosure was made in RPM's

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Form 10-Qs filed with the SEC. The SEC alleges the General Counsel made false and misleading representations to RPM's independent auditors by providing a range of loss that was well below the estimates known internally (and disclosed to the DOJ) and which ultimately informed RPM's settlement offer.

Following receipt of the DOJ's settlement counter-offer of $71 million in March 2013, which included a FCA damages multiplier, RPM recorded for the first time in April 2013 an accrual for the DOJ investigation in the amount of $68.8 million and disclosed the investigation in RPM's Form 10-Q that was filed with the SEC in April 2013. RPM ultimately settled the underlying FCA case in August 2013. In August 2014, RPM restated its financial results for the first, second and third quarters of fiscal 2013, recording accruals showing the company's best estimates of probable losses due to the investigation of $11 million, an additional $17 million, and an additional $40 million, respectively, which track with RPM's internal estimates at the corresponding times.

RPM maintains the restatements "had no impact on the audited results for the fiscal year ended May 31, 2013, and the company's audit committee concluded that there was no intentional misconduct on the part of any of its officers." Chairman and CEO, Frank C. Sullivan, stated, "We believe the allegations have absolutely no merit and are the product of prosecutorial overreach."

Accrual and Disclosure Requirements Under Accounting and SEC Rules

Information about "contingencies" is often among the more sensitive disclosures for a company and may be closely scrutinized by analysts and investors. Disclosure of pending lawsuits and government investigations also has the potential to impact an underlying proceeding, since adversaries may attempt to discern the company's outlook and strategy from the disclosure. SEC concern over contingencies disclosure has grown since the large loss contingency charges recorded during the financial crisis and resulted in increasingly aggressive government enforcement initiatives.

Public companies are required to disclose information about contingencies, such as litigation and governmental proceedings, in several areas of their periodic reports. For example, Item 103 of Regulation S-K requires disclosure about pending legal proceedings, while Item 303 of Regulation S-K requires that a company describe (in its Management's Discussion and Analysis) certain types of "trends and uncertainties" as well as items that may affect its liquidity. However, as a practical matter, the requirements under FASB Accounting Standards Codification Topic 450 ("ASC 450") (formerly Financial Accounting Standards No. 5)—which could require the accrual of a charge for a contingency or the disclosure of a contingency in the notes to the financial statements—often drive the most sensitive disclosures. The rules regarding whether or when a public company must disclose a government investigation or material litigation and/or make an accrual under ASC 450 and Regulation S-K disclosure guidelines often do not provide bright lines and involve numerous nuanced considerations. For a more in depth review of ASC 450 disclosure and accrual guidance, *see* http://www.kslaw.com/library/publication/PublicCompanyAdvisor-March2013.pdf.

Key Takeaways from the SEC's Complaint

In the RPM complaint, the SEC focuses on disclosures of potential losses arising out of government investigations, particularly when a company has identified and quantified potential wrongdoing and communicated this amount to the government in a settlement offer. This recent SEC action suggests several lessons to help general counsels, compliance officers and other members of the legal team avoid drawing similar scrutiny:

- **Transparency with key executives, audit committee, and internal finance and accounting individuals.** It is important to keep these key individuals reasonably informed with timely and accurate information

regarding the status of, and key updates with respect to, government investigations and potentially material litigation. If a *qui tam* complaint or other potentially material litigation has been filed, or other government investigations become known, inform these key individuals of the existence of that litigation.

- **Don't leave out the details.** When updating key executives and the audit committee, it isn't enough to inform them that an investigation or litigation is ongoing. Appropriate detail regarding material matters should be provided to the CEO, CFO, and audit committee, including internal damages analyses, the status of settlement negotiations (ongoing, anticipated initiation or lack thereof) and the potential financial parameters of settlement.

- **Coordinate with outside lawyers and independent auditors.** Create a process for handling attorney response letters delivered by outside law firms to the company's auditors. Designate both legal and accounting individual(s) at the company to review these letters to ensure accurate and complete information about loss contingencies from government investigations and other pending or threatened litigation is being delivered to company executives and independent auditors at appropriate times.

- **Internal analyses of estimated damages/wrongdoing should be produced and used with caution.** The SEC will view such analyses in hindsight, and, as in the RPM complaint, could assert that a loss was both probable and reasonably estimable based on any such analysis. It is important to make sure all key constituencies (legal, accounting and financial reporting) are aware of any such analysis being commissioned. In addition, use caution in sharing such analyses with adverse parties, such as the government, and consider whether disclosure to an adverse party sets the bottom of the range of loss.

- **Regularly monitor the status of settlement negotiations.** Consider the following factors while in settlement negotiations:

    - Has the company conducted an internal investigation/analysis to understand the scope of any problems and the potential impact?

    - If an internal investigation/analysis has produced a damages estimate, will this amount be shared with the adverse party/government in settlement negotiations?

    - Is the company's settlement offer based on acknowledged errors or on general considerations (*i.e.,* nuisance value, cost of defense, desire to appease important customer?) (Note that an offer is not, de facto, a reasonable estimate of the loss contingency.)

    - What is the range between the offer by the company and the demand by the adverse party/government and the likelihood of resolution? Do the offer and demand remain far apart or are they narrowing?

    - If intentional misconduct is involved, does the estimated amount include statutorily mandated damage multipliers or enhancements typically demanded by the government?

    - As a practical matter, has the company preserved its ability to withdraw its offer and proceed with litigation or does settlement seem inevitable?

    - Is there a track record of similar cases settling? On what basis and for what amounts?

Depending on these and other factors, companies may be required to disclose an investigation and/or record an accrual earlier rather than later in the process. Each situation presents unique circumstances for careful review and evaluation under ASC 450 and applicable provisions of Regulation S-K.

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