Professional Perspective

Assessing Loss Contingencies From Litigation and Regulatory Exposures

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The $2 million settlement of the SEC's enforcement action against RPM International Inc. is a good reminder of the need for public companies to properly assess exposures from pending or anticipated litigation, regulatory proceedings, and enforcement matters, and make reasonable judgments about whether to take a charge against net income by accruing for potential losses from such exposures.

Such exposures can have an appreciable impact on reported earnings. This need is even more pronounced as experienced professionals populate the enforcement and regulatory leadership positions at the Biden-led cabinet departments and independent agencies, such as the Department of Justice, Environmental Protection Agency, OSHA, and the Consumer Fraud Protection Bureau (CFPB). To illustrate the regulatory mindset companies may face, the CFPB Acting Director issued a statement stressing that the agency will be "reversing policies of the last administration that weakened enforcement and supervision." The SEC itself is expected to continue, if not expand, its policing of requirements that companies inform investors that they may be on the hook for monetary liabilities from alleged environmental, consumer, safety, anti-corruption, false claims, and other types of proceedings.

This article focuses on the accounting standards governing the booking and disclosure of loss contingencies, several related SEC actions alleging reporting and other violations and the factors likely to be considered by the SEC in assessing whether an enforcement action is warranted.

The requirements for reporting on loss contingencies are codified in Accounting Standards Codification Topic 450 (ASC 450), titled "Contingencies." This ASC topic provides guidance for the recognition and disclosure of a loss contingency—an existing condition, situation, or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future events occur or fail to occur, such as a lawsuit or government enforcement action. Under ASC 450, companies must assess whether the likelihood that a future event will confirm a loss is remote, reasonably possible, or probable.

• If a loss from a contingency is deemed probable and the amount of the loss can be reasonably estimated, ASC 450 requires the company to record its best estimate of the loss. Probable means the future event is likely to occur. It is generally interpreted as 70-80% likely. For example, Robinhood Financial recently disclosed that it has accrued $26.6 million, representing "the bottom of the range of our probable losses" from a possible negotiated resolution with the Financial Industry Regulatory Authority over outages, options trading and related matters.

• If a loss is probable but a reasonable estimate of the amount of the loss cannot be made, the company is required to disclose the nature of the contingency and a statement that such an estimate cannot be made. Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made.

• If an unfavorable outcome is not probable, but is reasonably possible, the company should disclose the contingency, along with the range of possible losses or a statement that the possible losses cannot be estimated. A loss is considered reasonably possible when the chance of the future event occurring is more than remote but less than likely. There is no exception for prejudicial information.

• If a loss is remote neither accrual nor disclosure is required. A loss is remote when the chance of the future event occurring is slight.

The $30 Million Lesson of *Mylan*

It has been previously observed by the then SEC's Deputy Chief Accountant that the recording of a material accrual for a contingent liability related to an event that occurred several years before should not be the first disclosure regarding that contingency. Further, while the low end of a range of possible losses is the right number if no amount within the range is more likely than any other, it is surprising when zero is the recorded loss right up until a large settlement is announced.

Disclosures and accruals should not be delayed until settlement is imminent. Disclosure of reasonably possible losses and accrual of probable losses are required unless the losses are not estimable, in which case statements to that effect are necessary. In the absence of required disclosure or accrual, the company is essentially asserting that the probability of loss is remote. The SEC and the company's auditors are rightly skeptical if something goes from remote or less than probable to settled in a short time. These views are illustrated by the action, *Securities and Exchange Commission v. Mylan N.V.* (D.D.C. filed September 27, 2019), pursuant to which Mylan agreed to pay a $30 million penalty.

The alleged accounting and disclosure failures related to a DOJ investigation into whether Mylan overcharged Medicaid for EpiPen, its largest drug by sales and profits. Starting in November 2014, and continuing for nearly two years, the DOJ focused on whether Mylan misclassified the EpiPen as a generic drug and thereby overcharged the government for EpiPen sales to Medicaid patients. As a generic, Mylan paid much lower rebates to the government than if the EpiPen had been classified as a branded drug. The DOJ issued multiple subpoenas, rejected Mylan's arguments to close the investigation, and indicated its intent to sue Mylan if Mylan failed to make a settlement offer. Mylan provided potential damage calculations and made offers of settlement.

The SEC charged that Mylan failed to disclose or accrue for the loss relating to the DOJ investigation before October 2016, when it announced a $465 million settlement with the DOJ. Without admitting or denying the SEC's allegations, Mylan agreed to a permanent injunction from violating the reporting provisions of the Securities Exchange Act and the anti-fraud provisions of the Securities Act that do not require scienter.

Exposure from Qui Tam Complaint for False Claim Act Violations

Even a short delay in booking an accrual can result in an enforcement proceeding. In *RPM International Inc.*, the SEC charged the company and its general counsel with violating the securities laws for failing to record an accrual or disclose a loss contingency for a pending DOJ investigation. The DOJ investigation focused on whether RPM overcharged the government on certain roofing contracts. The SEC alleged that RPM, in violation of ASC 450 and the securities laws, did not disclose the DOJ investigation, or record any accrual, until the third quarter of 2013. This was despite the fact that in the first and second quarters of 2013, RPM estimated that it overcharged the government by material amounts on the contracts at issue, and, in the second quarter, planned to settle with the DOJ. The DOJ investigation was resolved by a $60.9 million settlement in 2013.

The SEC alleged that the general counsel knew but failed to inform senior management and the audit committee that RPM sent DOJ several estimates that the company overcharged the government by at least $11 million, agreed to submit a settlement offer by a specific date, and that prior to submitting the settlement offer, RPM's overcharge estimates increased to at least $27 million. The SEC also alleged facts that the general counsel was sensitive to the company's desire to avoid further extraordinary charges following the company taking one-time charges totaling $56 million.

The lawsuit, filed in 2016, was settled in December 2020. Without admitting or denying the allegations of the complaint, the company agreed to pay a penalty of $2 million and to be enjoined from violating the reporting, books and records, and internal control provisions of the Exchange Act. The general counsel agreed to pay a penalty of $22,500 and to be enjoined from violating the books and records provision of Exchange Act Rule 13b2-1. The company had previously restated and recorded accruals in the first three quarters of FY 2013.

This case is a reminder that alleged False Claims Act violations and related qui tam complaints by insiders cutting across the federal government provide a continuing source of potential liabilities. Early warning signs of a problem—from agency audits, internal audits and whistleblower hotlines, among other sources—and a company's assessment of settlement and litigation risks under the treble damages and other provisions would be relevant factors in the SEC making a charging decision.

Warning Against Accruing Loss Over Time

This case illustrates the SEC's position that accruals cannot be made over time and a company cannot estimate loss and then accrue ratably through the estimated payment date or as the expense is incurred.

The SEC charged Advanced Emissions Solutions (AES), an environmental services company, with the failure to record a significant loss contingency in connection with an adverse arbitration ruling against the company. Based on the same findings, the SEC also sued the company's former chief financial officer in a civil injunctive action. The company lost an arbitration dispute with a manufacturer that alleged a joint venture partner of the company misappropriated trade secrets. The adverse award held the company liable for an amount calculated as a percentage of the gross revenue generated by the joint venture.

The SEC noted that the former CFO and others discussed how to record the adverse ruling in the upcoming quarterly report, and expressed concerns regarding the impact that the accounting for the adverse ruling would have on the company's business prospects. The SEC asserted that the CFO then circulated an analysis to management and directors that estimated an amount of over $36 million that the company could potentially record as a long-term liability with regard to the adverse ruling. The CFO then stated his estimates of the amount that AES would pay annually through 2018 to satisfy the award. According to the SEC's order, "under GAAP, a loss contingency in connection with the amount should have reflected within the financial statements since the liability was probable and reasonably estimable." However, the company failed to record the long-term liability. Instead, the company reported the expenses on a quarterly basis "as they were incurred."

AES, without admitting or denying the SEC's findings of violations of the anti-fraud provisions of the Securities Act that do not require scienter and the reporting and other provisions of the Securities Exchange Act, agreed to the entry of a cease-and-desist order and to pay a $500,000 penalty. The former CFO agreed to be suspended from participating in the financial reporting or audits of public companies, and consented to a permanent injunction and an officer and director bar and to pay $238,692.

Stand-Alone Internal Accounting Controls Violations and Product Recall Process

Not adhering to ASC 450's guidance for the recognition and disclosure of a loss contingency can produce enforcement actions without allegations of false disclosures or materially misstated financial statements. The General Motors (GM) case related to GM's processes for assessing exposures from recalls associated with faulty ignition switches. The SEC assessed a $1 million penalty, finding that GM failed to maintain a system that delivered to the responsible review group (Warranty Group) information that a recall was considered probable and the costs of such a recall were estimable.

While certain GM personnel understood that a defective switch presented a safety issue by the Spring of 2012, the Warranty Group did not learn of the issue until November 2013, at which point it accrued $41 million for estimated costs of recalling three models with the defective ignition switch. Without admitting or denying the SEC's findings, GM agreed to cease and desist from violating Section 13(b)(2)(B) of the Exchange Act, requiring the devising and maintaining an adequate system of internal accounting controls.

Conclusion

A new rotation of public servants will soon be up and running enforcement and regulatory units throughout the Biden administration. The ratcheting up of regulations, proceedings, and harder-than-before settlement negotiations are expected. Thus, this is the ideal time to review whether sufficient processes are in place to generate the information necessary to make difficult judgments on whether exposures exist that should be disclosed and/or accrued for. Clearly, application of ASC 450 requires a company to make judgment calls, and in some fact patterns, different parties might reasonably make different judgments. Even so, the proceedings discussed above furnish some guardrails to follow. In making charging decisions, the SEC will likely compare the timing when a material loss is disclosed or accrued with information, best estimates and advice known to the company, such as the results of an internal investigation, preliminary adverse rulings, settlement proposals, credible whistleblower complaints, and written assertions manifesting the regulator's belief that the agency has a claim. It would be prudent as judgment is documented and exercised to anticipate this enforcement mindset.