Understanding SEC Financial and Accounting Fraud Investigations

May 17, 2011
Agenda

• Introduction
• Presentation
• Questions and Answers — (anonymous)
• Slides — now available on front page of Securities Docket
  — www.securitiesdocket.com
• Wrap-up
Webcast Series

- Approximately every other week
- May 19, 2011: “Merger Litigation and Related Valuation Issues, Post Airgas”
Today’s Presenters

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Investigations, Accounting Fraud, and Related Economic Damages

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Topics to Be Covered in Today’s Webcast

• Legal Framework of Fraud Claims
• Recent SEC Updates
• Current Enforcement Trends of the SEC
• Types of Accounting Fraud
• Investigation Procedures and Best Practices
• Potential Measures of Damages in Accounting Fraud Matters
• Case Study in Common Law Fraud: Valassis v. ADVO
Legal Framework of Fraud Claims
Elements of a Common Law Fraud Claim

“Generally speaking, a claim for [common law] fraud must include the following elements: (1) a false statement of material fact; (2) defendant’s knowledge that the statement was false; (3) defendant’s intent that the statement induce the plaintiff to act; (4) plaintiff’s reliance upon the truth of the statement; and (5) plaintiff’s damages resulting from reliance on the statement.”

*Tricontinental Indus. Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 841 (7th Cir. 2007)
Fraud by Omission

A fraud claim based on intentional non-disclosure (i.e., omission), has the same elements as fraud, except that an omission is actionable as fraud only where there is an independent duty to disclose the omitted information. The duty to speak arises when one party has information “that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.”

*Chiarella*, 445 U.S. 222, 228 (1980) (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).
Duty to Speak

The duty to speak can arise when:

• Where one party is the only source of the information to the other party or the problems are not discoverable by other reasonable means;

• Disclosure is necessary to prevent an ambiguous or partial statement from being misleading;

• Subsequently acquired knowledge makes a previous representation false; or

• The undisclosed fact is basic to the transaction.

_Duquesne Light Co. v. Westinghouse Electric Corp.,_ 66 F.3d 607, 612 (3rd Cir. 1995)
“Plaintiff cannot sustain a cause of action for fraud if defendant’s misrepresentation did not form the basis of reliance.”


However, in an omissions case, if the fact omitted is material, reliance can be presumed. Affiliated UTE Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1971).
Elements of a Security Fraud Claim: Section 10(b) and Rule 10b-5

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange…

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”
Similar to common law fraud, the requisite elements of a rule 10b-5 claim are: a false statement or omission of material fact; make with scienter; in connection with the purchase or sale of securities upon which the plaintiff justifiably relied and which statement proximately caused the plaintiff’s damages.

*Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir. 1997).
Elements of a Security Fraud Claim: Section 10(b) and Rule 10b-5

Materiality requires “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.”


Causation has two necessary components:

- “transaction causation” – i.e., that the plaintiff would not have invested in the instrument if the defendant had stated truthfully the material facts at the time of the sale; and
- “loss causation” – the very facts about which the defendant lied caused plaintiff’s injuries.
Fraud-on-the-Market


- Idea that stock prices are a function of all available information about the company, therefore misstatements defraud the entire market and impact the price of the stock.

- The Fraud-on-the-Market theory establishes a rebuttable presumption of reliance and satisfies transaction causation.

- Absence of loss causation is relevant to showing that either (1) the alleged misrepresentation was not material or (2) the market was not efficient, either of which can rebut the presumption.
Recent SEC Updates
Recent SEC Updates

• In 2010, the SEC completed the reorganization of the Enforcement Division, which included the creation of five new specialized units:
  • Asset Management Unit (investment advisers, mutual funds)
  • Market Abuse Unit (complex market manipulation schemes)
  • Structured and New Products Unit (derivatives)
  • Foreign Corrupt Practices Act (FCPA) Unit (international bribery)
  • Municipal Securities and Public Pensions Unit

• These specialized units represent 25% of all enforcement staff and have hired industry experts to assist with investigative planning and strategy, witness testimony, and market analysis.
Recent SEC Updates, cont.

• The reorganized Enforcement Division is expected to more efficiently pursue potential actions.
  • Creation of the Office of Market Intelligence to analyze tips according to internally developed risk criteria and SEC priorities.
  • Cooperation initiative authorizes staff to enter into cooperation agreements
    • The SEC entered into its first nonprosecution agreement in December 2010.
  • Individuals may be rewarded for cooperation in investigations based on:
    • Assistance provided;
    • Importance of the underlying matter;
    • Societal interest of holding the person accountable; and
    • Personal and professional profile of the individual
Recent SEC Updates, cont.

• Enforcement Division activity has increased slightly in the past year.
  • 531 formal investigations opened in 2010 vs. 496 in 2009.
  • 681 enforcement actions in 2010 vs. 664 in 2009.
  • $1 billion of civil money penalties ordered in 2010 vs. $345 million in 2009.

• Budget constraints have slowed some aspects of the reorganization process and implementation of aspects of the Dodd-Frank Act, including the creation of a separate whistle-blower office.
The Dodd-Frank Act has provided the SEC with additional authority and enforcement tools.

- The Enforcement Division can now proceed administratively rather than in federal court.

  - Administrative actions comprised 429 of 681 total actions (63%) in 2010 compared to 352 of 664 (53%) in 2009.

  - Administrative proceedings allow more flexibility in settlements.

- The SEC’s Trial Unit prevailed in 95% of administrative proceedings in 2010.
Recent SEC Updates, cont.

- The Dodd-Frank Act has provided the SEC with additional authority and enforcement tools, cont.
  - The Enforcement Division can now use *reckless* conduct as a basis to prosecute individuals for aiding and abetting
    - Previous criterion was *knowingly* providing substantial assistance to the primary violator.
  - The SEC can also now charge control persons for the acts of controlled persons.

- The Dodd-Frank Act has enhanced the sharing of privileged work product among the SEC and other federal agencies.
Recent SEC Updates, cont.

- The Dodd-Frank Act has provided the SEC with additional authority and enforcement tools, cont.
  - The Dodd-Frank Act requires the creation of a whistleblower office.
    - Tips from whistleblowers have increased significantly in 2010.
    - Office of Market Intelligence receives 1 to 2 “high quality” tips per day.

- The Dodd-Frank Act expands clawback provisions of SOX 304
  - Covers all current and former executive officers rather than only CEO’s and CFO’s.
  - 3-year look back period from the point of the issuer’s restatement rather than 1-year.
  - Misconduct by the issuer can be used to apply clawback provisions to executives.
Current Enforcement Trends of the SEC
Current Enforcement Trends of the SEC

- Reverse mergers with Chinese companies
- Collateralized Debt Obligations Disclosure and Valuation
- Extensive use of § 17a(2) to pursue Directors and Officers for non-intent based fraud (i.e. negligence)
- Increase in criminal actions for insider trading (e.g. think Raj, Martha, and maybe soon Sokol)
  - Criminal actions for accounting fraud have lagged behind, but may catch up in the future
- Increased cooperation between the SEC and federal criminal enforcement
Current Enforcement Trends of the SEC – Reverse Mergers

- Shell company traded on American markets acquires a Chinese company, which effectively makes the Chinese company public.
- The Chinese company puts out inaccurate press releases or financial statements that drive up share prices.
- The insiders sell their shares once the price goes up.
- Examples of reverse mergers with problems include:
  - China Electric Motor
  - China Natural Gas
  - China MediaExpress Holdings, Inc.
  - China Agritech
- The SEC has created a task force to address the issue.
Current Enforcement Trends of the SEC – CDO Disclosure and Valuation

- The SEC has filed suits against Goldman Sachs, JP Morgan, Wachovia, and others alleging improper financial statement reporting related to Collateralized Debt Obligations (CDO’s).
- Wells Fargo settled the SEC suit against Wachovia in April 2011 for over $11 million.
- The SEC is pushing for more accurate fair value balance sheet presentation for CDO’s.
Types of Financial Statement Fraud
Definition of Financial Statement Fraud

“Financial statement fraud is the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.”

- Association of Certified Fraud Examiners
Summary of Types of Financial Fraud

- Asset Misappropriation
  - Cash Theft- Skimming, Cash Larceny,
  - Fraudulent Disbursements and Billing Schemes
  - Payroll and Expense Reimbursement Schemes
  - Inventory and Other Assets
- Bribery and Corruption
  - Kickbacks and Bid-Rigging Schemes
  - Economic Extortion and Illegal Gratuities
  - Conflicts of Interest
- Financial Statement Fraud
  - Fictitious Revenues/Expenses
  - Timing Difference
  - Concealed Liabilities and Expenses
  - Improper Disclosures and Asset Valuation
Common Types of Financial Statement Fraud

• Fictitious Revenues/Expenses
  • Sales involving phantom customers or legitimate customers but are fictitious
  • Sales with conditions
  • Over-billing
  • Kickbacks masked in the form of a fictitious expense

• Timing Differences
  • Matching revenues with expenses
  • Premature revenue recognition
  • Channel stuffing
  • Recording expenses in the wrong period
Common Types of Financial Statement Fraud, cont.

- Concealed Liabilities and Expenses
  - Liability/expense omissions (i.e., shifting liabilities to off-balance sheet, unconsolidated affiliates)
  - Capitalized expenses
  - Failure to disclose warranty costs and liabilities

- Improper Disclosures
  - Liability omissions
  - Subsequent events
  - Management fraud and related party transactions

- Improper Asset Valuations
  - Inventory valuation
  - Accounts receivable
  - Business combinations
Relevant Accounting Guidance

• Impact of Fair Value Accounting
• Revenue Recognition
• Contingencies
• Materiality
• Management Estimates
• International Financial Reporting Standards
Investigation Procedures and Best Practices
Detection of Financial Statement Fraud Schemes

- Common methods of financial statement fraud detection are as follows:
  - Employee and other tips
  - Whistleblower
  - Internal Audits
  - External Audits

- External Audits
  - Auditor is responsible to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - SAS 99 - Consideration of Fraud in a Financial Statement
  - Financial Statement Analysis
Investigation Procedures and Best Practices

• Determine scope and purpose of investigation
  • Obtain and review preliminary information about the alleged financial statement fraud
    • Materiality (Quantitative vs. Qualitative)
    • Consider the source – complaint, formal inquiry, informal
  • In-house vs. Outside Counsel

• Independent Committees
Investigation Procedures and Best Practices, cont.

- Conduct initial interviews and extensive document reviews
- Define the scope of the problem and identify likely sources of information
- Consider re-interviews of certain custodians
- Perform extensive document review
  - Send document preservation notices out immediately
  - Obtain hard drive and e-mail data
  - Large-scale document gathering and review requires organization
Investigation Procedures and Best Practices, cont.

- Maintain all documents in secured fashion
- Documentation of results of investigation:
  - Written report vs. oral report
  - Difference between conclusions and opinions
  - Avoid opinions regarding any party’s guilt or innocence
- Disclosure obligations (board, regulators, insurers, public)
- Set up investigation protocols in advance
- Filip memo (Title 9, Chapter 9-28.00)
Potential Measures of Damages in Accounting
Fraud Matters
Damages Issues

• “But For” Concept / Damage Theory Overview
• Lost Profits Model
• Destruction of Business Model
• Benefit of the Bargain
• Securities Fraud Damages
Damages Overview

• “But For” Concept

• Types of Damages / Remedies:
  • Monetary Damages
    • Compensable
    • Consequential
    • Punitive
  • Rescission or Rescissionary Damages
Legal Criteria in Proving Damages

- Causation
- Mitigation
- Reasonable Certainty
- Speculation
- Foreseeability
Measurement of Damages

Measure of Recovery

• Lost Profits

  Or

• Fair Market Value Before and After
Traditional Lost Profits Model

- **Pre-Impairment**
- **Post-Impairment**

**Unimpaired**

- **Date of Impairment**
- **Date of Retained Trial Date**

**Impaired**

- **Lost Profits**
- **Theory 1** Discount to Injury Date
- **Theory 2** Escalate Back/Discount Front Damages

Dollars vs. Years


- Traditional Lost Profits Model
Destruction of a Business Measure of Damages

Fair Market Value (Going Concern) $XXX
One Day Prior to the Impairment

Less: Value One Day After the Impairment (XXX)

Economic Damages/Diminution in Value $XXX
Benefit of the Bargain –
Common Measure of Damages

“The benefit of the bargain measure awards the [buyer] the difference between the gain had the misrepresentations been true and what the [buyer] actually received.”¹

The Impact of Dura Pharmaceuticals on Damage Analysis In Securities Fraud Cases

- In Section 10(b) securities claims, class members may generally recover no more than the difference between the price paid for the security and its true value at the time of purchase absent the misrepresentation.
- A plaintiff must link the stock loss directly to the misrepresentation or omission.
- A lower stock price following a corrective disclosure does not, on its own, establish loss causation or damages attributable directly to the misrepresentation.
- Changes in stock price may well reflect a number of factors, including "changed economic circumstances, changed investor expectation, new industry- specific or firm- specific facts, which taken separately or together account for some or all of that lower price."

Limitations on Securities Fraud Damages

- Damages in a securities class action may not exceed the difference between the price paid by the class member for the security and the average trading price of the security during the 90-day period after the corrective disclosure.

- If a corrective disclosure causes only a temporary drop in the stock price, recoverable damages are limited accordingly and may be non-existent.

15 U.S.C. § 78u-4(e)
Fraud in a Merger and Acquisition Case: Valassis v. ADVO
Facts of the Case

• Valassis and ADVO are in the direct mail advertising business. Each company had sales in excess of $1B. The combined entity will exceed $2.65B in sales.

• Late in 2005 Valassis commenced merger discussions with ADVO.

• On July 7, 2006, Valassis and ADVO signed the SPA, whereby, Valassis would pay $37/share in cash.
PRIOR to the signing of the SPA, ADVO represented:

- Forecasted operating income for FY2006 of $68 million;
- The integration of their SDR computer system was progressing as planned;
- That the April & May 2006 financial statements were materially correct.

The SPA is signed on July 5, 2006.
Facts of the Case, cont.

• **AFTER** the signing of the SPA:
  
  • ADVO disclosed that April and May’s 2006 financial statements were misstated by $2.6M;
  
  • August 10, 2006, ADVO adjusted its $68 million forecasted operating income to $54.8 million, nearly identical to an internal April 2006 forecast of $54.5 million;
  
  • Actual FY results ending 9/30/06 were $37.9 million, some $30 million below expectations.

• Negotiations stalemated. On October 31, 2006 Valassis filed suit to rescind the merger.
Assignment

Investigate the following allegations:

- Financially speaking, did ADVO’s business suffer a materially adverse change? More specifically:
  - Was ADVO’s EBITDA materially misstated?
  - Did ADVO sustain a dramatic downturn?
  - Was ADVO performing disproportionately below its peers in the industry?
  - Was ADVO’s downturn known to the buyer prior to closing?
- Did Valassis obtain the benefit of its bargain?
Demonstration of Dramatic Downturn
ADVO’s Recent Operating Income is Below the Historical Mean
Declined 70% From Q1 2006 to Q4 2006

Mean = $19.5

($ in Millions)

Q1 2003: $20.0
Q2 2003: $18.7
Q3 2003: $21.6
Q4 2003: $21.3
Q1 2004: $19.8
Q2 2004: $20.7
Q3 2004: $21.6
Q4 2004: $22.4
Q1 2005: $14.1
Q2 2005: $18.5
Q3 2005: $14.1
Q4 2005: $22.1
Q1 2006: $12.6
Q2 2006: $11.6
Q3 2006: $7.0
Q4 2006: $14.1
ADVO’s Business Has Deteriorated Significantly

Operating Income ($ in Millions)

<table>
<thead>
<tr>
<th></th>
<th>Q3 2006</th>
<th>Q4 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected</td>
<td>$18.0M</td>
<td>$19.1M</td>
</tr>
<tr>
<td>Actual</td>
<td>$9.6M</td>
<td>$4.8M</td>
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</table>

Difference:

-61.2%

Projected Second Half FY 2006:

- $37.1M

Actual Second Half FY 2006:

- $14.4M
ADVO’s Material Misrepresentation
ADVO’s Fiscal Year 2006
Operating Income Forecasts

($) in Millions

- 4/14/2006: $54.5
- 5/10/2006: $68.6
- 6/23/2006: $68.0
- 7/6/2006: $54.8
- 8/10/2006: $37.9
- Actual (unaudited)

(Merger Agreement)

(Original Budget)
ADVO Operating Below Industry Expectations
ADVO’s Performance is Disproportionate to the Industry

($ in Millions)

Change

(4.3)%

(69.5)%

Time between Q1 & Q4

Industry Average*  
ADVO

<table>
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<tr>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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</thead>
<tbody>
<tr>
<td>Q1</td>
<td>Q2</td>
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<td>Q4</td>
</tr>
<tr>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
</tr>
<tr>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
</tr>
</tbody>
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Katten Muchin Rosenman LLP

Critical Thinking at the Critical Time™
Benefit of the Bargain Analysis

- ADVO was valued based on the financial performance expected by Valassis in July 2006 (prior to signing) and in August 2006 (after signing).

- Valassis utilized both the Market and Income approaches in valuing ADVO.

- Valassis paid a control premium in its acquisition of ADVO.
Market Approach
Guideline Company Analysis

• A multiple of EBITDA was utilized based on the companies deemed comparable in the industry.

• Valassis initially priced ADVO at approximately 11 times EBITDA. Given the decline in the business, a 9 times EBITDA multiple was determined to be more appropriate.
Valassis Did Not Receive the Benefit of its Bargain

### Purchase Price Overpayment Calculation

<table>
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<tr>
<th>Description</th>
<th>Value</th>
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<tbody>
<tr>
<td><strong>In Millions (except multiples)</strong></td>
<td><strong>9.0x Multiple</strong></td>
</tr>
<tr>
<td>Pre-Signing Forecasted Fiscal '06 Op. Income - Misrepresentation</td>
<td>$68.0</td>
</tr>
<tr>
<td>Less: Pre-Signing Forecasted Fiscal '06 Op. Income – Realistic</td>
<td>(54.5)</td>
</tr>
<tr>
<td><strong>Operating Income Misrepresentation</strong></td>
<td>$13.5</td>
</tr>
<tr>
<td><strong>% of Misrepresented Operating Income</strong></td>
<td>19.9%</td>
</tr>
<tr>
<td>ADVO '06 EBITDA (Valassis/Bear Stearns Projection)</td>
<td>$119.0</td>
</tr>
<tr>
<td>Less: Misrepresentation</td>
<td>(13.5)</td>
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<tr>
<td>Corrected ADVO '06 EBITDA</td>
<td>$105.8</td>
</tr>
<tr>
<td>EV/EBITDA Purchase Price Multiple</td>
<td>9.0x</td>
</tr>
<tr>
<td>Adjusted Enterprise Value</td>
<td>$950</td>
</tr>
<tr>
<td>Less: Actual Enterprise Value Purchase Price</td>
<td>(1,291.3)</td>
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<tr>
<td><strong>Purchase Price Overpayment</strong></td>
<td>$(341.8)</td>
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<tr>
<td><strong>% of Actual Purchase Price</strong></td>
<td>26.5%</td>
</tr>
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Income Approach
Discounted Cash Flow Valuation

• The forecasted cash flows and discount rate were adjusted to reflect the downturn in the business.

• Valassis revised the revenue assumptions downward which translated into a revised cash flow analysis.
ADVO’s Historical & Projected Revenue Per Thousand Pieces

($) Revenue/Thousand Pieces

Year


$37.64 $36.75 $36.48 $36.20 $36.89 $37.71* $37.36 $36.68 $36.45 $37.72 $38.28 $38.44 $38.63 $38.93 $39.56 $39.44 $39.50 $39.65 $40.36 $40.78

- ADVO Projection as of July 5, 2006
- Valassis Original Projection
- Valassis Revised Projection
Valassis Did Not Receive the Benefit of its Bargain
ADVO Misled Valassis into
Overpaying by $300 - $400 Million
($) in Millions

<table>
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<tr>
<th>Multiple of EBITDA Based on Guideline Companies</th>
<th>Income Approach (Free Cash Flow)</th>
</tr>
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<tbody>
<tr>
<td>Value at July 5, 2006&lt;sup&gt;(1)&lt;/sup&gt;</td>
<td>$1,291</td>
</tr>
<tr>
<td>FY 2006 EBITDA&lt;sup&gt;(3)&lt;/sup&gt;</td>
<td>$105.5</td>
</tr>
<tr>
<td>Multiple</td>
<td>9.0x</td>
</tr>
<tr>
<td>Value at August 10, 2006</td>
<td>950</td>
</tr>
</tbody>
</table>

($342)

| Value at August 10, 2006<sup>(2)</sup> | 676 |

($404)
Q&A Session
Thank You for Attending This Webcast