Investigations, Accounting Fraud, and Related Economic Damages

December 8, 2009

Agenda

- Introduction
- Presentation
  - Andrew Gifford, DLA Piper
  - Ron Lepinskas, DLA Piper
  - Jeff Litvak, FTI Forensic and Litigation Consulting
  - Gary Kleinrichert, FTI Forensic and Litigation Consulting
- Questions and Answers — *(anonymous)*
- Slides — now available on front page of Securities Docket
  - www.securitiesdocket.com
- Wrap-up

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- January 12— **Causes and Economic Consequences of Merger & Acquisition Disputes**

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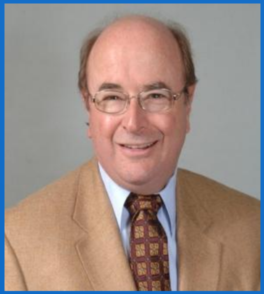
Panel

Ron Lepinskas

Andrew Gifford



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Investigations, Accounting Fraud, and Related Economic Damages

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Topics to Be Covered in Today's Webcast

- Introduction of the Case Study: ABC Corporation
- Legal Framework of Fraud Claims
- Types of Accounting Fraud
- Detection of Financial Statement Fraud
- Legal Defenses to Fraud
- Potential Measure of Damages in an Accounting Fraud Matter
- Case Study: ABC Corporation

Introduction of Case Study: ABC Corporation

ABC Corporation: Case Assumptions

Assumptions Regarding ABC Corporation Accounting Fraud:

- Corporation intentionally inflated revenues and profits over the past five years
- Had the true financial condition and results of operations been known, the corporation would have been insolvent in year one and most likely have liquidated at the end of year one
  - Auditors were misled, as corporation kept two sets of books

ABC Corporation:
Case Assumptions, cont.

Assumptions Regarding ABC Corporation Accounting Fraud, cont.:

- Plaintiff contends many red flags should have been known to the auditors and to the lead lending group
  - Unrealistic inventory levels
  - Excessive profit margins which were never met by an industry competitor
  - Excessive growth so rapidly that it should have been questioned
- Claims have been brought forth by the Liquidation Trustee against perpetrators (auditors and lead lender) of the allleged fraud

Legal Framework of Fraud Claims

Direct Misrepresentation

"Fraud at common law included a scheme to deprive a victim of his entitlement to money. For instance, a debtor who concealed his assets when settling debts with his creditors thereby committed common-law fraud."

Pasquantino v. United States, 544 U.S. 349, 357 (2005).

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Elements of a Modern Fraud Claim

"Generally speaking, a claim for 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

"[O]ne who fails to disclose material information prior to consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary or other similar relationship of trust and confidence between them.'"

Chiarella v. United States, 445 U.S. 222, 227-28 (1980) (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

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Reliance

"Plaintiff cannot sustain a cause of action for fraud if defendant's misrepresentation did not form the basis of reliance."

Sec. Inv. Protection Corp. v. BDO Seidman, L.L.P., 95 N.Y.2d 702 (N.Y. 2001).

Blame Game: Tag the Auditor

"Despite the limited role of auditors and the inherent risk involved in conducting business in today's society, the investing public tends to blame the auditor when it is hurt financially by a business failure."

Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218, 221 (Iowa 1991).

Types of Accounting 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*

Accounting Fraud- Recent SEC Updates

- Effective on November 17, 2009, President Obama established an interagency Financial Fraud Enforcement Task Force.
- The mission of the task force is to provide advice and make recommendations to the Attorney General for the investigation and prosecution of financial crimes.
- The task force will work with state and local partners to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate financial crimes, address discrimination in the lending and financial markets and recover proceeds for victims.

Accounting Fraud – Recent SEC Updates, cont.

The SEC Enforcement Division has undergone one of the most significant reorganizations in its history:

- From January 2009 to September 2009, the SEC has:
  - Issued approximately 448 formal orders compared to 181 orders in 2008
  - Filed 62 emergency actions compared to 30 actions in 2008
  - Opened more nearly 50 more investigations than opened in 2008
- According to Fulbright's Litigation Trends Survey, one in seven of the largest company respondents expect an increase in the number of regulatory proceedings against their company over the next twelve months.
- Regulatory actions against financial services companies are up sharply from 18% in 2008 to 31% in 2009.

Accounting Fraud- Recent SEC Updates, cont.

- In the first half of 2009, the SEC has emphasized financial reporting cases related to following areas:
  - The collapse of the subprime mortgage market
  - Prosecution of manipulative accounting entries
  - Outstanding stock options backdating cases originated in ‘06
- Accounting irregularities are increasingly showing up in regulatory filings and corporate announcements (i.e. Apollo Group, Overstock.com, and Zale)
- According to a KPMG survey, one-third of corporate executives have expected that fraud and misconduct would rise in their organizations this year.

Accounting Fraud – Recent SEC Updates, cont.

In the wake of the Madoff fraud, the SEC has been taking steps to reduce the chances that such frauds will occur or be undetected in the future. These comprehensive steps are as follows:

- Safeguarding Investors' Assets
- Revitalizing the Enforcement Division
- Revamping the Handling of Complaints and Tips
- Advocating for a Whistleblower Program
- Conducting Risk-Based Examinations of Financial Firms

Accounting Fraud – Recent SEC Updates, cont.

Additional comprehensive preventative steps taken by the SEC in the wake of the Madoff fraud are as follows:

- Increasing Focus on Agency-Wide Risk Assessment
- Improving Fraud Detection Techniques for Examiners
- Seeking More Resources
- Integrating Broker-Dealer and Investment Adviser Examinations
- Enhancing Licensing, Education and Oversight Regime for "Back-Office" Personnel

Summary of Types of Accounting 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
- Tax Accounting
- International Financial Reporting Standards
- Other Accounting

Detection of Financial Statement Fraud

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

The Role of the External Auditor

SAS 99- Consideration of Fraud in a Financial Statement establishes standards and provides guidance to auditors regarding misstatements and financial statement fraud.

- Description and characteristics of fraud
- Importance of exercising professional skepticism
- Discussion among engagement personnel regarding risk of material misstatement due to fraud
- Obtaining information needed to identify risks of material misstatements due to fraud

The Role of the External Auditor, cont.

Additional considerations of SAS 99 are as follows:

- Identifying risks that may result in material misstatement due to fraud
- Assessing the identified risks after taking into account an evaluation of the entity’s programs and controls and responding to the results of the assessment
- Evaluating audit evidence
- Communicating about fraud to management, the audit committee, and others
- Documenting the auditor’s consideration of fraud

Legal Perspective: The Auditor's Duty

"It was the [auditor's] duty to protect creditors of and investors in [its client] from being misled to their harm by financial statement issued by [the auditor's client] that contained errors that would be material to a creditor or investor"

"It was not [the auditor's] duty to give the company business advice, such as advice on whether to acquire another company."

Maxwell v. KPMG LLP, 520 F.3d 713, 716 (7th Cir. 2008)

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Legal Perspective: The Auditor's Duty, cont.

"An auditor's failure to independently verify financial statements may give rise to a claim for fraud, especially where the auditor 'had notice of particular circumstances raising doubts as to the veracity of . . . such information.'"

Houbigant, Inc. v. Deloitte & Touche LLP, 303 A.D.2d 92 (N.Y. App. Div. 2003)

Finding triable question of fact as to auditor's failure to recognize $57 million overstatement of client's intangible assets.

Maxwell v. KPMG LLP,
520 F.3d 713 (7th Cir. 2008)

- Technology consulting company acquired larger rival in 2000 via $7 billion stock transaction

- Technology consulting company filed for bankruptcy in 2001 after dot.com bust

- Bankruptcy trustee sued auditor for professional negligence seeking $600 million in damages related to alleged errors in earnings release and 8-K

- Court granted summary judgment because auditor's alleged negligence was not cause of company's failure

- Auditor's duty was to protect creditors and investors from being misled by financial statements, not to provide business advice whether to acquire competitor

Investigation Procedures and Best Practices

Investigation Procedures and Best Practices

- Determine scope and purpose of investigation (note: purpose may change over time)
  - Obtain and review any and all 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 Committee

Investigation Procedures and Best Practices, cont.

- Conduct initial interviews prior to extensive document reviews in order to define the scope of the problem and identify likely sources of information
  - Document review will result in some re-interviews of certain custodians
- Perform extensive document review
  - Be sure to send document preservation notices out immediately
  - Obtain hard drive and e-mail data as soon as possible
  - Large-scale document gathering and review requires organization

Investigation Procedures and Best Practices (cont.)

- Safeguard and maintain all documents
  - Best to copy all documents or maintain them on a secured network site
- Extent of documentation of results of investigation
  - Written report vs. oral report
  - Recognize the difference between conclusions and options
  - Avoid stating opinions regarding the guilt or innocence of any person or party
- Disclosure obligations (board, regulators, insurers, public)
- Set up investigation protocols in advance
- Filip memo (Title 9, Chapter 9-28.00)

Legal Defenses to Fraud

Duty

"The audit report might flunk Accounting 101, but if the report didn't mislead anyone toward whom the auditor had a duty of care, the auditor would not have committed a tort."

Johnson Bank v. George Korbakes & Co., LLP, 472 F.3d 439, 442 (7th Cir. 2006)

Note: Divergence among state law concerning the scope of an auditor's duty -- *Ultramares*, Restatement of Torts § 552

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Imputation/In Pari Delicto

"The phrase *in pari delicto* means in equal fault."

"No one is permitted to profit by his own fraud, or to take advantage of his own wrong, or to found a claim on his own iniquity, or to acquire any rights by his own crime."

In re Oakwood Homes Corp., 340 B.R. 510, 536 (Bankr. D. Del. 2006) (internal quotations and citations omitted).

AHERF v. PwC, 2008 WL 3895559 (3d Cir. 2008)

- Pennsylvania healthcare company engaged in aggressive acquisition strategy throughout the 1980's and 1990's
- Healthcare company, with the knowledge of its chief financial officer, intentionally misstated financial statements in 1996 and 1997 to mask financial problems
- Healthcare company filed for bankruptcy in 1998
- Federal trial court granted summary judgment on in pari delicto
- Currently on appeal to Pennsylvania Supreme Court via certified question from Third Circuit

Causation

"Loss causation is the proximate causal link between the alleged misconduct and the plaintiff's economic harm. To establish loss causation a plaintiff must show, that the economic harm that it suffered occurred as a result of the alleged misrepresentations."

Graham v. Barriger, 2009 WL 3852461, at *12 (S.D. N.Y. 2009).

Contributory Negligence: The Audit Interference Rule

Traditional rule: A client's contributory negligence is only a defense if the client interfered with the auditor's engagement.

Shapiro v. Glekel, 380 F. Supp. 1053 (S.D. N.Y. 1974).

Modern rule: The jury may consider client negligence including, but not limited to, client omissions during the audit process and disregard of the auditor's recommendations under a comparative negligence regime.

Bank of Brussels Lambert v. Chase Manhattan Bank, N.A., 1996 WL 728356 (S.D. N.Y. 1996).

Potential Measures of Damages in an Accounting Fraud Matter

Definition of Damages

Damages are the monetary compensation which the law awards to one who has been injured by the action of another.

Types/Measures of Damages

- **Direct Damages** – the natural and probable result of the breach
- **Incidental Damages** – costs or expenses relating to mitigating the breach or in enforcing legal rights under the contract
- **Consequential Damages** – no clear and universal definition or understanding
  - Typically do not arise as an immediate, natural and probable result of the act done, but from the interposition of an additional cause, such as the nonbreaching party's dealings with third parties
  - Lost profits are often considered consequential damages

Types/Measures of Damages, Cont.

- **Disgorgement-** Measure of damages which equate to the wrongdoers profits illegally obtained
- **Lost Profits-** Measure of damages which equate to the pre-tax profit assuming no breach versus actual pre-tax profits
- **Destruction of Business Damages-** Fair market value (FMV) one day prior to the breach less the FMV/Liquidation value after the breach

Types/Measures of Damages, Cont.

- **Out of Pocket Costs-** Actual value at the time of the transaction less value as received
- **Benefit of the Bargain-** Value as bargained for versus the value as received
- **Deepening Insolvency-** Damages based on the theory of a wrongful prolongation of corporate life, which measures the harm based on the increase in the deficit net worth of a corporation incurred over time

Contract and Fraud Damages

- Damage awards are generally designed to put the non-breaching or fraudulent party in the position it would have enjoyed had there been no breach or fraudulent activities
- Often referred to as **"expectancy damages"** which give the non-breaching party the "benefit of the bargain" (Also as a measure of damages for fraud)
  - Damages must be calculated with reasonable certainty and not be speculative
  - Damages must flow from the breach and be reasonably foreseeable

Fraud Damages

There are two measures of damages for **fraud**:

- **Out of Pocket Costs-** directed to restoring the plaintiff to the financial position enjoyed by him prior to the fraudulent transaction
  - Actual Value at the time of the transaction, less
  - Value as received
  - Calculated at the time of the transaction
- **Benefit of the Bargain-** concerned with satisfying the expectancy interest of the defrauded plaintiff by putting him in the position he would have enjoyed if the false representation relied upon had been true
  - Value as bargained for, less
  - Value as received
  - Calculated as of the date the fraud was discovered
- **Damages for fraud, only recoverable, if proximately caused by the misrepresentation**

Damage Theory: Deepening Insolvency

- The Deepening Insolvency Theory:
  - Seeks recovery for the expansion of corporate debt due to the wrongful prolongation of corporate life
  - Seeks recovery based on increased balance sheet insolvency over the wrongful prolonged life of the corporation may be a remedy in certain tort cases
  - Increases risk of exposure of legal action for audit professionals

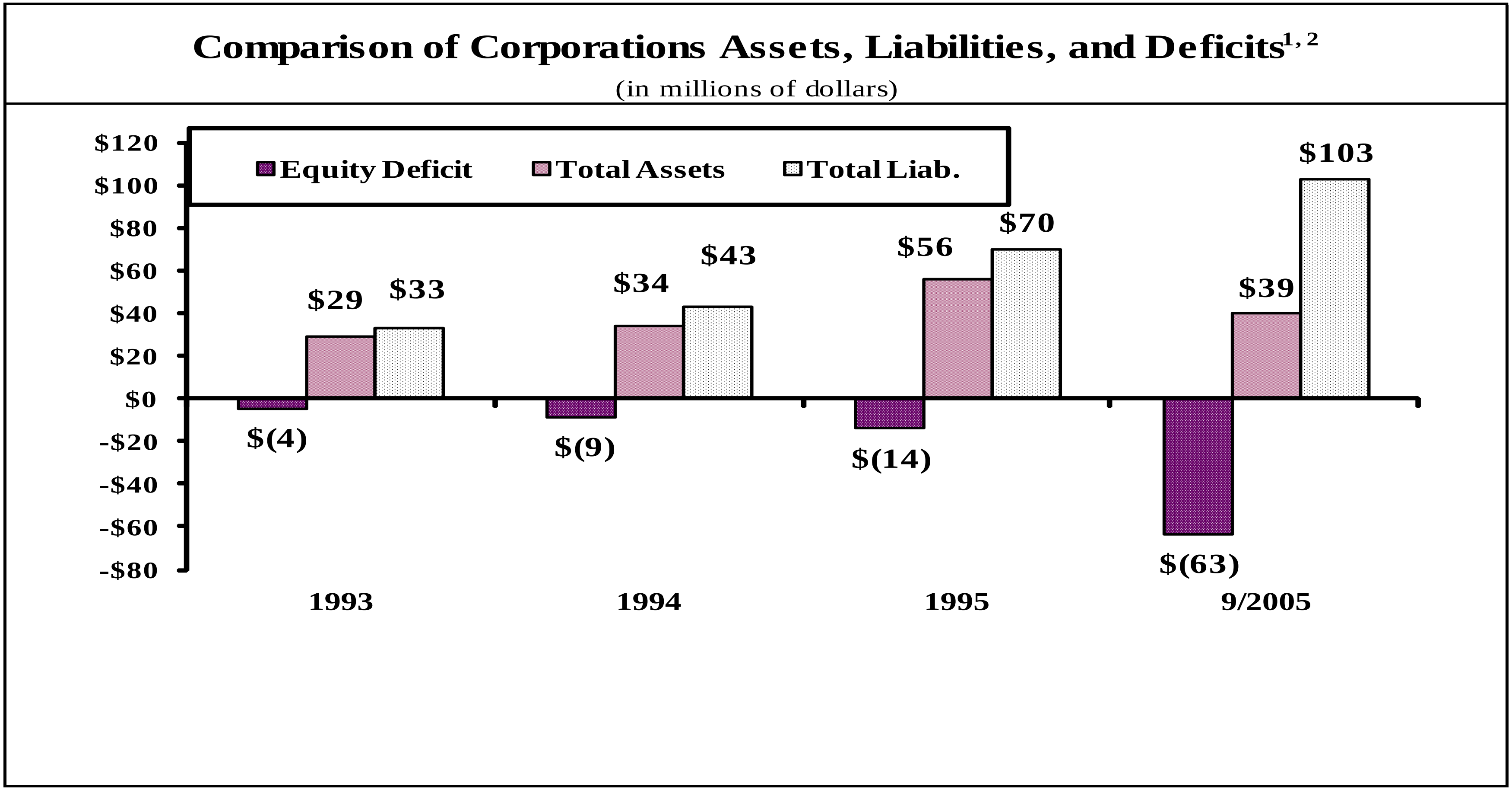
Critique of the Deepening Insolvency Theory

- As a matter of economics and finance, this theory is not an appropriate measure of economic harm to a corporation
  - The equity value of a corporation cannot be below zero
    - When an equity surplus exists and assets exceed liabilities, it means the corporation has equity value (the corporation is solvent)
    - When an equity deficiency exists and liabilities exceeds assets, it means the corporation has no equity value (the corporation is insolvent)

Critique of the Deepening Insolvency Theory, cont.

- Economically, the equity value cannot be below zero because the corporate structure includes limited liability for its equity holders
  - Creditor obligations will not be paid, as the equity deficiency does not represent some amount owed by the corporation to pay additional creditor obligations
  - Accounting losses incurred to derive a net equity deficiency is not a measure of economic loss to a corporation- may be potential harm to the creditors

Example: Auditor malpractice is alleged to have “deepened the insolvency” from 1993 to 2005 from $(4)M to $(63)M



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Example: Observations of auditor malpractice that alleged to have "deepened the insolvency"

- Observations:
  - Since the equity value from 1993-2005 was zero, the accounting deficit is not a measure of damages to be paid by the corporation
  - Given the deficit net worth from 1993-2005, it is highly unlikely that an investor would acquire the corporation
  - At best, the increase in liabilities may be damages to the creditors, but not damages to the corporation

Schacht v. Brown: The Original Case of "Deepening Insolvency"

- In 1979 an insurer slid into receivership
- Claim: the insurer had concealed its insolvency for five years; management diverted profitable business to benefit themselves
- Auditor sued for failing to detect the insolvency
- Auditor's defense: prolonging the corporation's life is no harm
- "Fraudulent prolongation" of the insurer's life led to "increased exposure to creditor liability"

Parmalat: Deepening Insolvency As Damages Theory, Not as Claim

- An Italian dairy conglomerate collapsed in 2003
- Insiders used offshore companies to hide debt and make up revenue
- Liquidator sued the auditors for malpractice etc.
- Liquidator claimed that insiders had squandered $10 billion b/c the auditors had not detected fraud
- Deepening insolvency rejected as tort, accepted as damages theory

Ambassador: "Deepening Insolvency" In Spirit, Though Not in Name

- In 1984 an insurer sank into receivership
- Auditor erred by $24M on loss reserves; it had received $50K in fees for the audit
- The receiver sued the auditor for not crying "insolvency!"
- Jury was not instructed on deepening insolvency
- The auditor must now pay <u>$183 million</u> to the receiver

What Damages Don't Fall Into This Theory?

- **Powerfully simple measure of damages**
- **"Intervening cause" in concept only**
  - Looting & criminal acts can become auditor's problem
  - Market changes too
- **Issues of fact for the jury**

Courts vs. Nonsense

- Restrictions in theory
- Damages usually involves fact issues for the jury
- Courts usually allow damages experts to testify
- Hypothetical basis of “deepening insolvency”

Observations from the Front

- “Tip of the iceberg” – unreported decisions & settlements
- Real problem? Receivers/trustees, juries, others…
- Engagement letters & arbitration clauses
- The price of conservatism: a lost equity claim
- But … consider the source

Case Study: ABC Corporation

ABC Corporation: Accounting for Fraud Damages

- Summary of Corporate Claims
  - Perpetrators of Fraud
    - Amounts diverted from corporation
      - Personal/corporate waste
      - Interest payments on debt
    - Corporate lost profits
    - Diminution in equity value of corporation

ABC Corporation: Accounting for Fraud Damages, cont.

- Summary of Corporate Claims, cont.
  - Auditors
    - Audit Fees
    - Amounts diverted from corporation
      - Personal/corporate waste
      - Interest payments on debt
    - Lost profits
    - Diminution of equity value of corporation
    - Deepening insolvency

ABC Corporation: Accounting for Fraud Damages, cont.

- Summary of Claims, cont.
  - Lead Lending Group
    - Lenders fees
    - Corporate waste
    - Interest payments
    - Creditor loss of investment
  - Creditors may be able to recover:
    - Lenders' fees
    - Loss of investment
    - Loss of interest payments

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ABC Corporation: Damage Observations

- Observations
  - Fraud damage claims are complex because:
    - Bankruptcy and insolvency issues
    - Causation/apportionment of liability issues, particularly for those defendants other than the perpetrators of the fraud
  - Damages in a fraud case are measured based upon:
    - The out of pocket cost theory, or
    - The benefit of the bargain

ABC Corporation: Damage Observations, cont.

- The Deepening Insolvency Theory may be alleged by the plaintiff
  - Troublesome, because economically speaking the theory lacks merit
  - Given a corporation equity value cannot decrease below zero, an increase in the equity deficiency is not damages sustained by the corporation.


Shareholder Activism
Management
Auditors
Ownership And Sustainability
Allegations
Lure of LBOs
高階主管

Q&A Session

Thank You

Thank you for attending this webcast.