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Expert Analysis

The Rise of the Stealth Restatement: Securities Litigation Accounting Fraud Trends

By Michelle A. Reed, Esq., and Jessica Greenwood, Esq.
Akin Gump Strauss Hauer & Feld

Following the 2008 financial crisis, the Securities and Exchange Commission channeled significant resources to prosecuting crisis-related misconduct. With crisis cases nearing completion, the SEC has expressed renewed interest in accounting fraud, including establishing the Financial Reporting and Audit Task Force and implementing new data-mining software to detect accounting irregularity (commonly referred to as RoboCop).

The SEC's focus on accounting fraud will likely prompt class-action plaintiffs and the courts, among others, to pay greater attention to corporate restatements, which frequently lead to allegations of accounting irregularities. This commentary examines historic trends in corporate restatements and securities litigation alleging accounting fraud and suggests future trends.

RESTATEMENTS: A HISTORIC VIEW

Section 409 of the Sarbanes-Oxley Act requires publicly traded companies to promptly disclose "material changes in their financial condition or operations."[1] Pursuant to Section 409, registrants must make a disclosure in Item 4.02 of their annual 8-K filings if their prior financial statements "should no longer be relied upon because of an error in such financial statements."[2] A traditional restatement occurs when a company amends its prior financial statements following an Item 4.02 disclosure.

In many cases, public companies restate financials in a periodic filing, like a Form 10-K, without first making an Item 4.02 disclosure. Such restatements are referred to as "revision restatements," or "stealth restatements," and are used when an amendment is not sufficiently material to make the prior financial restatement unreliable.[3]

Since 2006, the total number of corporate restatements, including revision restatements, has generally declined.[4] Despite this downward trend in restatements, two underlying patterns are worth noting. First, although restatements have decreased for all public companies, restatements have increased for companies listed on the New York Stock Exchange and traded over the counter. Specifically, restatements filed by NYSE companies numbered 108 in 2011, up from just 65 in 2009.[5]

Second, while the total number of restatements has declined, the percentage of stealth restatements has increased significantly over the last five years. Revision restatements made up just 41.5 percent of restatements in 2007, but accounted for 64.5 percent of restatements in 2012.[6]

HISTORIC TRENDS IN SECURITIES LITIGATION: CLASS ACTIONS AND SEC ENFORCEMENT

Like restatements, SEC enforcement actions alleging accounting fraud have seen a decline in recent years. In 2007, 33 percent of all SEC enforcement actions alleged financial fraud or improper issuer disclosures.[7] Beginning in 2008, the SEC turned its attention away from accounting fraud and towards crisis-related misconduct. The SEC's accounting fraud task force was disbanded, replaced by units investigating Ponzi schemes and malfeasance in the mortgage-backed securities market.[8]

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Financial fraud was alleged in 23 percent of SEC enforcement actions filed in 2008. By 2012, just 11 percent of SEC enforcement actions alleged financial fraud. That same year, allegations of financial fraud made up the largest specific category of whistle-blower tips provided to the SEC.[9] Following the confirmation of Mary Jo White as SEC chairman in April 2013, SEC enforcement officials publicly indicated renewed interest in accounting fraud. For example, a senior SEC enforcement official was quoted by The Wall Street Journal as saying the SEC needs to be "more proactive in looking for [accounting fraud]" and "[t]here's a feeling internally that the issue hasn't gone away."[10]

Historic trends in class-action securities litigation are more complex. In the last five years, securities class-action filings were at their highest in 2008, when there were 223 filings. There were 152 securities class-action filings in 2012. Between 2008 and 2012, the percentage of securities class actions alleging fraud under Rule 10b-5 fluctuated, with a low of 66 percent in 2010 and a high of 85 percent in 2012. Most securities class actions since 2008 have alleged misrepresentations in financial documents. The percentage of cases alleging violations of generally accepted accounting principles, or GAAP, has decreased by nearly half since 2008, from 42 percent of cases in that year to 23 percent in 2012.

Much of this decrease is attributable to the decrease in credit crisis cases, which disproportionately involved allegations of GAAP violations. In half of the 2012 class actions alleging GAAP violations, the corporate defendant announced that its financials would be restated or should no longer be relied upon. Overall, however, corporate restatements were announced in only 11 percent of securities class actions filed in 2012.[11]

THE CURRENT STATE OF THE LAW

To establish a securities fraud claim under Rule 10b-5, a plaintiff must plead and prove the defendant made a materially false or misleading statement:

- In connection with the sale of securities.
- With *scienter*, or fraudulent intent.
- Causing plaintiff's reliance on the fraud.
- Causing loss to the plaintiff.[12]

To defeat a motion to dismiss a Rule 10b-5 claim, a plaintiff must allege sufficient facts to raise a plausible inference as to each of these elements, and to support a strong inference of scienter.[13] If a Rule 10b-5 claim survives a motion to dismiss, the plaintiff must bring forth evidence to support each element to avoid summary judgment.[14]

Since restatements amend prior financial statements, the claim that the defendant made a false or misleading statement is rarely disputed in securities cases involving restatements. In at least one recent case, however, a court has considered whether the restatement of false information was sufficiently "material" to state a Rule 10b-5 claim. For the most part, recent cases involving restatements and Rule 10b-5 allegations focus on whether the fact of a restatement- standing alone or in conjunction with other allegations- is sufficient to support a strong inference or finding of *scienter*.

In *Dobina v. Waterford International Ltd.*[15] the court found that a tax understatement, standing alone, was insufficient to allege *scienter*. The defendant corporation in *Dobina* understated its tax expenses for 2007 to 2010 by over $500 million, requiring the issuance of a restatement. The corporation announced that, due to improper internal controls, its effective tax rate had been grossly underestimated.

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In evaluating the plaintiffs' Rule 10b-5 claim, the court said the "magnitude" of a restatement "can be relevant to the *scienter* inquiry." However, given the possibility that the tax understatement was the result of an innocent mistake compounded over time — coupled with the plaintiffs' failure to allege that any defendant had a contemporaneous reason to know of the miscalculation — the court refused to draw an inference of *scienter.*

Similar to *Dobina*, the court in *Proter v. Medifast Inc.*[16] rejected the plaintiffs' contention that the "[s]ize, duration, and simplicity of GAAP" violations underlying restatements by Medifast, Inc. strongly suggested *scienter*. The court first noted that Medifast's 2011 restatement, which revised income downward by $523,000 for 2008 and by $606,000 for 2009, did not approach the millions of dollars in restatements that supported an inference of *scienter* in prior cases. Next, the court held that the longevity of GAAP violations involved did not show scienter. The court rejected as conclusory the plaintiffs' argument that, because Medifast's 2010 restatement put it on notice of accounting weaknesses, Medifast must have known about separate GAAP violations prompting its 2011 restatement.[17] Finally, the court held that the simplicity of the GAAP violations did not suggest Medifast acted with *scienter*, particularly considering that Medifast and its external auditor "were in agreement during this period as to the application of revenue recognition."

In *In re Diamond Foods Inc. Securities Litigation,*[18] the court reached the opposite conclusion from *Dobina* and *Proter*, finding that the "magnitude of the wrongful accounting" underlying a restatement was sufficient to support a strong inference of *scienter. Diamond* arose out of an agreement for Diamond Foods Inc. to purchase the Pringles chip brand. The sales price was a mixture of cash and Diamond common stock, with the cash component adjusting depending on the value of Diamond common stock at the closing date. According to the plaintiffs, Diamond artificially increased the price of its common stock, thus reducing the cash component of the sales price, by failing to recognize costs associated with its walnut business in the same periods as it received related revenues. Shortly after Diamond restated its earnings to correct the issue, Diamond's stock price fell by 36.9 percent.

In holding that Diamond's deferred accounting of its walnut costs supported a finding of *scienter*, the court said it was a "basic and fundamental" violation of GAAP, and was an unprecedented practice within Diamond. The court also found that *scienter* was sufficiently alleged against individual corporate officers, who were closely involved in Diamond's accounting practices and participated in misleading corporate statements about the proper accounting of walnut costs.

In *North Port Firefighters' Pension-Local Option Plan v. Fushi Copperweld Inc.,*[19] the court likewise found sufficient allegations of both materiality and *scienter* based on Fushi Copperweld, Inc.'s restatement. As to materiality, Fushi argued that its restatement was immaterial because, for the several years involved, Fushi's earnings were adjusted downward by only 4 percent. Rejecting this netting approach, the court found that the restatement was material as to each period at issue, because Fushi's income was adjusted upward or downward by at least 8 percent and as high as 24 percent each period.

Next, the court found sufficient *scienter* allegations. The court said Fushi had misrepresented whether a cross-currency interest swap, which allows companies to hedge the volatility of currency and interest rates, was entitled to cash flow hedge accounting. Not all swaps, however, are entitled to use hedge fund accounting treatment, which allows entities to smooth the risk of foreign currency exposure. According to the plaintiffs, the swap transaction was "plain vanilla" from an accounting standpoint, such that Fushi must have known or recklessly disregarded the fact that the swap did not qualify for hedge fund accounting treatment. On the other hand, the transaction was extremely complex from the perspective of a reasonable investor, who likely relied on Fushi's statements in assessing the appropriate treatment of the swap. The court rejected Fushi's defense that it had relied on advice from an independent auditor, noting that such reliance "does not confer immunity nor can such an issue be decided at [the] pleading stage."

While many of the recent Rule 10b-5 cases involve allegations of restatements at the motion-to-dismiss stage, at least one court has considered the weight of a restatement as summary judgment evidence. In *In re Federal National Mortgage Association Securities, Derivative & ERISA Litigation,*[20] the court rejected the plaintiffs' reliance on restatements as summary judgment "evidence" or "admissions" of *scienter*. First, the court said the restatements by Fannie Mae were "post-hoc reports" that drew no conclusions about whether a particular corporate officer actually knew or consciously disregarded improper accounting practices. Next, the court reminded the plaintiffs that — as the court had cautioned at the motion-to-dismiss stage — the "sheer scope" of fraudulent accounting practices does not alone establish fraudulent intent.

LOOKING FORWARD

The recent overall decline in corporate restatements, coupled with the underlying increases in revision restatements and restatements by NYSE and OTC companies, has left commentators speculating about the future of accounting fraud claims and restatements. Some argue that the downward trend in total restatements has merely concealed an ongoing problem with accounting fraud.[21] Under this view, the SEC's recent focus on accounting fraud is symptomatic of a larger issue that the agency has left under-investigated in recent years.

At the other end of the spectrum, some suggest that the rise in revision restatements — seen as less serious than traditional restatements — may actually signal a reduction in the occurrence and severity of accounting issues.[22] Under the latter view, increased SEC enforcement of accounting fraud is seen as the cause of, rather than a response to, the rise in restatements filed by NYSE and OTC companies.

The SEC's RoboCop will likely result in increased investigations, as well as securities class actions, related to accounting fraud. The new Financial Reporting and Audit Task Force will focus on preparation of financial statements, issuer reporting and disclosure, and audit failures, with the goal of fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures. The accounting data-mining software will analyze whether a company is an outlier from other similar companies and will also analyze irregularities in companies' own historical accounting using the accounting quality model. It will examine key fraud risk areas, including accruals (which are non-cash entries with the potential for manipulation by management), proportion of off-balance-sheet transactions, frequent changes in auditor and delays to earnings announcements. This new approach may lead to increased investigations and accordingly increased prosecutions and class actions.

Although restatements are not conclusive of securities fraud, companies facing potential restatements must be continually mindful of satisfying their disclosure obligations while protecting against unsubstantiated allegations of accounting fraud.

NOTES

1. 15 U.S.C. § 78m(l) (2012).

2. *See* U.S. Sec. & Exch. Comm'n Form 8-K, Item 4.02, *available at* http://www.sec.gov/about/forms/form8-k.pdf.

3. *See* Audit Analytics, 2011 Financial Restatements: An Eleven Year Comparison 7 (2012).

4. *See* Audit Analytics, 2012 Financial Restatements: A Twelve Year Comparison 1 (2013).

5. *See* Audit Analytics, 2011 Financial Restatements: An Eleven Year Comparison 3 (2012).

6. *See* Audit Analytics, 2012 Financial Restatements: A Twelve Year Comparison 7-8 (2013).

7. Cornerstone Research, Securities Class Action Filings: 2012 Year in Review 23 (2013).

8. Francine McKenna, *Is the SEC's Ponzi Crusade Enabling Companies to Cook the Books, Enron-Style?,* Forbes, Oct. 18, 2012, http://www.forbes.com/sites/francinemckenna/2012/10/18/is-the-secs-ponzi-crusade-enabling-companies-to-cook-the-books-enron-style/.

9. Cornerstone Research, Securities Class Action Filings: 2012 Year in Review 21-23 (2013) (including chart indicating 18.2 percent whistle-blower tips relating to financials, and 23.4 percent relating to unspecified "other" allegations).

10. Jean Eaglesham, *Accounting Fraud Targeted,* Wall St. J., May 28, 2013, at C1 (quoting Scott Friestad, senior SEC enforcement official).

11. *See* Cornerstone Research, Securities Class Action Filings: 2012 Year in Review 3, 5-6 (2013); *see also* Ellen M. Ryan & Laura E. Simmons, Cornerstone Research, Securities Class Action Settlements: 2012 Review and Analysis 12 (2013).

12 17 C.F.R. § 240.10b-5 (passed pursuant to 15 U.S.C. § 78j (2012)).

13 *See, e.g., Dobina v. Weatherford Int'l Ltd.,* No. 11 Civ. 1646 (LAK), 2012 WL 5458148, at *3 (S.D.N.Y. Nov. 7, 2012).

14 *See, e.g., In re Fed. Nat'l Mortgage Ass'n Sec., Derivative & ERISA Litig.,* No. 04-1639 (RJL), 2012 WL 5869386, at *3 (D.D.C. Nov. 20, 2012).

15 *Dobina*, 2012 WL 5458148, at *1, 10-11.

16 *Proter v. Medifast Inc.,* No. GLR-11-720, 2013 WL 1316034, at *14-15 (D. Md. Mar. 28, 2013).

17 *See also Janbay v. Canadian Solar Inc.,* No. 10 Civ. 4430, 2013 WL 1287326, at *9 (S.D.N.Y. Mar. 28, 2013) (rejecting plaintiffs' argument that a revision of fourth-quarter earnings in one year could serve as proof that "irregularities" existed in "unidentified sales transactions" in prior periods, noting that plaintiff had not alleged specific facts to show wrongdoing in the prior period. Revising financial statements in one period does "not alone demonstrate fraud or falsity of statements in other periods.").

18 *In re Diamond Foods Inc. Sec. Litig.,* No. C 11-05386 WHA, 2012 WL 6000923, at *1-2, 8, 11-12 (N.D. Cal. Nov. 30, 2012).

19 *N. Port Firefighters' Pension-Local Option Plan v. Fushi Copperweld Inc.,* No. 3:11-cv-00595, 2013 WL 866943, at * 39-40, 42 (M.D. Tenn. Mar. 7, 2013).

20 *In re Fed. Nat'l Mortg. Ass'n,* 2012 WL 5869386, at *11.

21 *See, e.g.,* McKenna, *supra* note 8.

22 *See, e.g.,* Stephen Juris, *Restatements Resurrected?,* Forbes, Mar. 28, 2013, http://www.forbes.com/sites/insider/2013/03/28/restatements-resurrected-accounting-fraud-by-the-numbers/.

Michelle Reed (L), partner at **Akin Gump Strauss Hauer & Feld** in Dallas, focuses her practice on complex civil litigation, with an emphasis on representing public companies and their officers and directors in securities litigation, internal investigations, and regulatory and enforcement proceedings. She can be reached at mreed@akingump.com. **Jessica Greenwood** (R) is a litigation associate in the firm's Dallas office, with a practice focusing on complex civil litigation matters, particularly in federal court. She can be reached at jgreenwood@akingump.com.