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SEC ENFORCEMENT

The SEC's Renewed Interest in Accounting Cases —A New Beginning or a Victim of *Fait* ?

BY LINDA L. GRIGGS, JOHN J. HUBER, AND CHRISTIAN J. MIXTER

On July 2, 2013, the Securities and Exchange Commission ("SEC" or "Commission") announced the formation of a Financial Reporting and Audit Task Force within the Division of Enforcement "dedicated to detecting fraudulent or improper financial reporting, whose work will enhance the Division's ongoing enforcement efforts related to accounting and disclosure fraud."[1] This initiative appears against the backdrop of a pronounced decline in the population of accounting and financial disclosure cases brought by the Commission, from 25 percent of all SEC enforcement actions filed in the 2003-2005 era to a mere 11 percent of all SEC enforcement actions filed in the fiscal year ended on September 30, 2012.[2]

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Last February, George Canellos, then Acting Director and now Co-Director of the SEC's Division of Enforcement, predicted a renewed emphasis by the Commission on accounting fraud cases. [3] However, Mr. Canellos also noted the substantial hindrance to accounting cases that is presented by the U.S. Court of Appeals for

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[1] *SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis*, Press Rel. No. 2013-121 (July 2, 2013).

[2] Jean Eaglesham, *Accounting Fraud Targeted*, WALL ST. J., May 28, 2013, at C1. A similar downturn in accounting cases can be demonstrated from the prevalence of Accounting & Auditing Enforcement Releases among all SEC litigation and administrative proceedings releases; using that benchmark, accounting cases have declined from 24 percent of the SEC's enforcement activity in the SEC's fiscal year 2007 to less than 10 percent in fiscal year 2012.

[3] *See SEC to Use Dodd-Frank Tool to Pursue 'Irresponsible' Gatekeepers*, 45 SEC. REG. AND L. REPORT 287 (BNA) (Feb. 18, 2013).

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the Second Circuit's 2011 decision in *Fait v. Regions Fin. Corp.*,[4] which held that certain kinds of numbers that appear in financial statements – specifically, goodwill and loan loss reserves – are, in substance, statements of opinion, and can only be found to be false statements under the federal securities laws if the plaintiff can show not only that the ''numerical opinion'' was materially wrong, but also that the speaker subjectively disbelieved it at the time the financial statements were issued. Mr. Canellos also forecast that the SEC increasingly may choose to focus its enforcement efforts on shortcomings in the Management's Discussion and Analysis of Financial Condition and Results of Operations (''MD&A'') disclosures in public companies' SEC filings, rather than the financial statements that appear in those same filings.[5]

This article addresses the observations of senior Commission officials regarding the future course of accounting and financial disclosure cases, whether brought by the SEC or private plaintiffs. In Section I, we focus on *Fait* itself and the manner in which it has been applied. Section II considers the wide potential sweep of *Fait* in view of the increasing prevalence of estimates and opinions in modern financial disclosure. Section III explores the suggestion that cases alleging violations of the federal securities laws governing the MD&A could take the place of more traditional accounting cases and also discusses the role of other sections of the securities laws regarding internal control and books and records. Section IV then offers suggestions to public companies on how to navigate in this new litigation environment.

I. The Roots and Branches of *Fait*

This section discusses the scope and origins of *Fait*, the interplay between the *Fait* holding and the concept of scienter under the federal securities laws, and the decisions that have applied *Fait* to accounting and financial disclosures of various types.

A. The Holding in *Fait*, and Its Roots in *Va. Bankshares*. *Fait* was a case brought under Sections 11 and 12 of the 1933 Securities Act (the ''Securities Act''),[6] in which the plaintiff alleged that Regions Financial Corp. (''Regions'') had materially misstated the goodwill associated with its November 2006 merger with AmSouth Bancorp., as well as Regions' loan loss reserves. In its February 2008 filing on Form 10-K, Regions reported $6.6 billion in goodwill attributable to the AmSouth acquisition, and total loan loss reserves across its operations of $555 million. Less than one year later, in January 2009, Regions issued an earnings release that reported a $6 billion non-cash charge for impairment of goodwill, and doubled its loan loss provision to $1.15 billion. Between the filing of the Form 10-K and the issuance of the earnings release, a Regions subsidiary issued 13.8 million shares of trust preferred securities in a public offering registered under the federal securities laws.

The plaintiff in *Fait* mounted a traditional Section 11/Section 12 attack on Regions' goodwill and loan loss reserve numbers, contending that those numbers were materially wrong and that, under the ''strict liability/affirmative defense'' regime of Sections 11 and 12, plaintiff needed to show nothing more than material incorrectness to survive defendants' motion to dismiss. The defendants contended otherwise, arguing that goodwill and loan loss reserve numbers are, in effect, numerical opinions in the financial statements. Relying on the U.S. Supreme Court's 1991 decision in *Va. Bankshares, Inc. v. Sandberg*,[7] Regions argued that, where disclosures regarding opinions are concerned, the plaintiff must plead and prove not only that the opinion/disclosure was objectively incorrect, but also that the speaker did not truly hold the opinion expressed at the time it was made and published. The district court agreed with the defendants.[8] Plaintiff appealed.

In affirming the district court's order dismissing the complaint, the Second Circuit framed the issue as follows:

> Although sections 11 and 12 refer to misrepresentations and omissions of material *fact*, matters of belief and opinion are not beyond the purview of these provisions. However, when a plaintiff asserts a claim under section 11 or 12 based upon a belief or opinion alleged to have been communicated by a defendant, liability lies only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed.[9]

The court of appeals then analyzed goodwill and loan loss reserves under both Financial Accounting Standards Boards (''FASB'') pronouncements and applicable caselaw. As to goodwill – which is the excess of the purchase price of the assets acquired in a business combination over the fair value of the assets acquired and the liabilities assumed, and which must be tested at least annually for impairment – the Second Circuit noted that, where management lacks a quoted market price for the assets, management must estimate their fair value. In the court of appeals' view, the need to estimate fair value introduced a subjective element that, in turn, made the amount of goodwill booked an opinion, akin to the statements by the directors in *Va. Bankshares* that the transaction at issue there offered shareholders a ''high'' value and a ''fair'' price.[10] The Second Circuit applied the same analysis to plaintiff's allegations that Regions' loan loss reserves were materially inadequate, observing that loan loss reserves, too, are inherently subjective and involve ''estimates [that] will vary depending on a variety of predictable and unpredictable circumstances.''[11] Because the plaintiff had not pointed to any objective standard for setting loan loss reserves, and also had not alleged that Regions' statements regarding those reserves were framed as guarantees, the court ruled that under *Va. Bankshares*, plaintiff must allege that defendants' opinions were both false and not honestly believed.[12]

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[4] 655 F.3d 105 (2d Cir. 2011).

[5] *See also* Elisse B. Walter, Commissioner, SEC, Speech at Stanford Directors College (June 25, 2013), *Corporate Disclosure: The Stage, the Audience and the Players* (stressing importance of MD&A).

[6] 15 U.S.C. §§ 77k, 77l.

[7] 501 U.S. 1083 (1991).

[8] *Fait v. Regions Fin. Corp.*, 712 F. Supp .2d (S.D.N.Y. 2012).

[9] 655 F.3d at 110.

[10] *Id.* at 110-112.

[11] *Id.* at 113.

[12] *Id.* To buttress the point that Regions had made no guarantees regarding its loan loss reserves, the Second Circuit quoted extensively from Regions' disclosures, in which Regions explicitly noted its belief that its loan loss reserves were adequate, but added that if its assumptions were wrong, it

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Did the Second Circuit's application of *Va. Bankshares* in *Fait* blaze a new trail? As we will see below, it did so only in certain respects. *Va. Bankshares* arose under Section 14(a) of the 1934 Securities Exchange Act (''Exchange Act'') and Rule 14a-9 thereunder,[13] which prohibit the solicitation of proxies by means of false or misleading statements. In the district court, the plaintiff minority shareholders had won a jury verdict that the defendant bank directors violated those provisions through a proxy solicitation in which they had urged the adoption of a merger proposal and a plan to pay the minority shareholders $42 per share because, in the directors' view, the plan afforded the minority shareholders the opportunity to achieve a ''high'' value and a ''fair'' price for their stock.

On certiorari from the U.S. Court of Appeals for the Fourth Circuit's ruling that the directors' ''high value'' statement was a legitimate basis for liability, the Supreme Court addressed the question ''whether a statement couched in conclusory or qualitative terms purporting to explain directors' reasons for recommending certain corporate action can be materially misleading within the meaning of Rule 14a-9.''[14] The Court concluded that it could, holding that:

> Under § 14(a), then, a plaintiff is permitted to prove a specific statement of reason knowingly false or misleadingly incomplete, even when stated in conclusory terms. In reaching this conclusion we have considered statements of reasons of the sort exemplified here, which misstate the speaker's reasons and also mislead about the stated subject matter (*e.g.*, the value of the shares). A statement of belief may be open to objection only in the former respect, however, solely as a misstatement of the psychological fact of the speaker's belief in what he says. In this case, for example, the Court of Appeals alluded to just such limited falsity in observing that ''the jury was certainly justified in believing that the directors did not believe a merger at $42 per share was in the minority stockholders' interest but, rather, that they voted as they did for other reasons, *e.g.*, retaining their seats on the board.''[15]

The Supreme Court then considered the question whether the defendants' disbelief in the opinion expressed could, standing by itself, be enough to create liability under Section 14(a) in the absence of proof that the statement in question asserted something false about the subject matter addressed.[16] Citing concerns over strike suits, the Court ruled that subjective disbelief in the opinion, in the absence of proof that the opinion in fact was materially wrong, would be insufficient to support a case.[17]

Perhaps because of the jury's verdict and the particular question posed on certiorari, the Supreme Court did not explicitly address the reverse case – one in which the plaintiff proves that an opinion was objectively, and materially, wrong, but in which the opinion was sincerely believed by the speaker. That task was taken up by Justice Scalia in his concurring opinion, which began with the following statement:

> As I understand the Court's opinion, the statement ''In the opinion of the Directors, this is a high value for the shares'' would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the directors honestly believed otherwise.[18]

That reverse case, of course, arises far more frequently than the somewhat empty example of a factually correct opinion that the speaker does not subjectively believe. As a result, Justice Scalia's concurrence has been widely cited by the courts, including the Second Circuit in *Fait*,[19] that have considered the ''opinion'' issue.

In the years since *Va. Bankshares* was decided, its approach to opinions has not been limited to Section 14(a) cases. Instead, several courts of appeals have applied it to other federal securities laws and rules that involve disclosure,[20] all of which share the same conceptual core – whether the disclosure contains a false statement of material fact. In the words of the Second Circuit in *Fait*, in all those contexts the *Va. Bankshares* ''approach makes logical sense. Requiring plaintiffs to allege a speaker's disbelief in, and the falsity of, the opinions or beliefs expressed ensures that their allegations concern the factual components of those statements.''[21] Nor was *Fait* the first ruling by a federal court of appeals to apply *Va. Bankshares* to numbers in a financial statement. Other appellate courts had previously used the *Va. Bankshares* approach to analyze claims related to loan loss reserves, one of the two types of accounts considered in *Fait*.[22]

The Second Circuit's innovation in *Fait* lay in its application of *Va. Bankshares* to a goodwill account and, far more important, in its suggestion – through its use of the concept of impairment from the accounting lit-

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would have to adjust them in the future. *Id*. n.6. As this part of the *Fait* opinion illustrates, registrants that include narrative disclosure in their risk factors, in the business section, or in the MD&A explaining the risks and uncertainties that underlie opinions will bolster their defense that investors were not misled as to the substance of the opinion. *See, e.g., In re Donald J. Trump Casino Sec. Litig. – Taj Mahal Litig.*, 7 F.3d 357, 373 (3d Cir. 1993) (''the accompanying warnings and cautionary language served to negate any potentially misleading effect that the prospectus' statement about the Partnership's belief in its ability to repay the bonds would have on a reasonable investor'').

[13] 15 U.S.C. § 78n(a); 17 C.F.R. § 240.14a-9.

[14] 501 U.S. at 1087.

[15] *Id*. at 1095 (citation omitted).

[16] *Id*. at 1095-96. Taking advantage of the jury's verdict, the Court held that the requirement of ''objective'' falsity had been met on the record presented in the *Va. Bankshares* case.

[17] *Id*.

[18] *Id*. at 1108-09 (Scalia, J., concurring).

[19] 655 F.3d at 111.

[20] *See, e.g., City of Omaha, Neb. Civilian Emps. Ret. Sys. v. CBS Corp.*, 679 F.3d 64, 67-68 (2d Cir. 2012) (Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b)); *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009) (Section 11 of the Securities Act); *In re IBM Corp. Sec. Litig.*, 163 F.3d 102, 106-11 (2d Cir. 1998) (Section 11 of the Securities Act and Section 10(b) of the Exchange Act); *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d at 372 n.14 (Sections 11 and 12 of the Securities Act). A notable counterexample is the Sixth Circuit's view, expressed most recently in *Ind. State Dist. Council v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013), that use of the *Va. Bankshares* standard in Section 11/Section 12 cases would inappropriately inject a scienter element into Securities Act claims that have no such requirement. *Omnicare* is more fully discussed in Section I(B) below.

[21] 655 F.3d at 112.

[22] *See, e.g., United States v. Morris,* 80 F.3d 1151, 1162-65 (7th Cir. 1996); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 282-83 (3d Cir. 1992).

erature – that ''numerical opinions'' may lurk in many of the numbers that appear in financial statements. As we will see in later sections, that innovation has been applied to a number of financial disclosures outside *Fait*'s specific examples of goodwill and loan loss reserves (*see* Section I(C)), and its *potential* application is broader still (*see* Section II). However, before we consider the factual sweep of *Fait*, it is worth placing *Fait* in the context of the legal theories that underlie accounting and disclosure cases that the SEC, and private plaintiffs, might bring.[23]

B. The Legal Consequences of Applying *Fait* in Accounting Cases. *Va. Bankshares* and *Fait* both recognized that opinions, while not immune from the federal securities laws, pose a special case under those laws just as they do in life and logic. Unlike a statement of fact (''*x* exists''), which can be falsified by adequate proof that x does not exist, a statement of opinion (prototypically, ''I believe that *x* exists'') carries different informational content and can only be falsified by proof that the speaker did not, in fact, hold that opinion at the time it was made/published. For good policy reasons rooted in concern over frivolous lawsuits, the Supreme Court held in *Va. Bankshares* that mere proof that the speaker did not hold the opinion will not state a claim under the federal securities laws in the absence of proof that the opinion held was, in fact, incorrect — thus giving rise to decisions, like *Fait*, that require a plaintiff in an opinion case to prove both that the speaker did not hold the opinion in question (sometimes called ''subjective falsity'') and that the opinion is wrong (sometimes called ''objective falsity''). But the fundamental holding of the *Va. Bankshares* line of cases is that proof of subjective disbelief, while not sufficient in itself, is necessary to proving that a statement of opinion is a *false* statement.

Proof of subjective disbelief in a statement of opinion therefore is antecedent to, and different from, proof of the speaker's scienter in making the statement.[24] Correctly placing ''subjective disbelief'' of an opinion statement in the element of falsity, and not scienter, is no mere academic exercise. Scienter must be shown under some disclosure statutes and rules, notably Section 10(b) of the Exchange Act and Rule 10b-5 thereunder,[25] but by no means all of them. In contrast, proof of a false (or, sometimes, an ''untrue'') statement is required under every disclosure statute and rule. Thus, *Fait's* holding with respect to ''numerical opinions'' poses a challenge to SEC accounting and financial disclosure cases, including those brought under non-scienter-based statutes and rules such as Section 17(a) of the Securities Act[26] and Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder,[27] as well as to private accounting and financial disclosure cases brought under Sections 11 and 12 of the Securities Act.

Unfortunately for analytical clarity, a number of decisions confuse the proof of ''subjective falsity'' needed to show that an opinion is a *false* statement with proof of scienter.[28] Perhaps the court most closely associated with this problem is the United States Court of Appeals for the Sixth Circuit, which has held that the *Va. Bankshares* rule for statements of opinion cannot be applied in Section 11/Section 12 cases because it would impose a scienter element that would conflict with the Supreme Court's equally well-known holding in *Herman & MacLean v. Huddleston*[29] that no such element exists under those statutes.[30] In fact, the use of *Va. Bankshares* in the context of non-scienter statutes poses no such conflict because, as noted above, the *Va. Bankshares* standard has nothing to do with scienter, but only with the proof needed to demonstrate that a statement of opinion is, in fact, false – an element of Section 11 and Section 12 as well as every other disclosure statute and rule.[31]

Does *Fait*'s requirement that the plaintiff show subjective falsity have any practical consequences in cases brought under statutes and rules, like Section 10(b) and Rule 10b-5, that already require the plaintiff, including the SEC, to prove scienter? The answer would appear to

[23] Outside the scope of this article are: (1) occasional citations of *Fait* in the context of defense arguments that broad statements of corporate optimism are ''mere puffery'' and therefore not actionable, *e.g. Billhofer v. Flamel Techs., S.A.*, No. 07 CIV 9920, 2012 BL 192977, at *11-12 (S.D.N.Y., July 30, 2012) (finding non-actionable a CEO's statement that ''We are pleased with the early success of the COREG CR launch''); and (2) *Fait's* somewhat more frequent use in the current debate over the liability of rating agencies for their opinions, *e.g., Ohio Police & Fire Pension Fund v. Standard & Poor's Fin. Servs. LLC*, 700 F.3d 829 (6th Cir. 2012).

[24] This point is perhaps most clearly illustrated in cases like *Fed. Hous. Fin. Agency v. UBS Americas, Inc.*, 858 F. Supp. 2d 306, 324 (S.D.N.Y. 2012), *aff'd on other grounds*, 712 F.3d 136 (2d Cir. 2013), in which an issuer incorporates a third-party opinion in a filing but in which it is the issuer, and not the author of the opinion, whose liability is at stake. In such a case, the ''subjective disbelief'' inquiry would focus on the author of the opinion, whereas the scienter requirement, if any, would apply to the issuer. Where the author of the opinion is the Company, the issues of ''subjective disbelief'' and scienter will overlap in many cases, but it is not difficult to imagine a case in which a speaker subjectively disbelieves an opinion but nevertheless does not intend to violate the federal securities laws, perhaps because he/she does not believe the opinion to be material, or perhaps because – as discussed in the text below – the speaker truly, but recklessly, holds an objectively incorrect opinion.

[25] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

[26] 15 U.S.C. § 77q(a). Section 17(a) of the Securities Act lacks a private right of action, and can only be enforced by the Commission. The Commission's need to show scienter depends upon the particular clause of the statute under which the defendant is sued. In *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court held that Section 17(a)(1) bore sufficient linguistic similarity to Section 10(b) of the Exchange Act that the Commission must show scienter for an (a)(1) violation. *Id.* at 695-97. In contrast, the Court ruled that no scienter is required to prove that a defendant has violated Sections 17(a)(2) or 17(a)(3). *Id.* at 697.

[27] 15 U.S.C. § 78m(a); 17 C.F.R. § 240.13a-1, -13.

[28] *Omnicare,* 757 F.3d at 503-507 ; *In re Gen. Elec. Co. Sec. Litig.*, 856 F. Supp.2d 645, 660 (S.D.N.Y. 2012); *City of Monroe Emps. Ret. Sys. v. Hartford Fin. Servs. Grp.*, No. 10 Civ. 2835 (NRB), 2011 BL 238186, at *14 (S.D.N.Y. Sept. 19, 2011).

[29] 459 U.S. 375, 382 (1983).

[30] *Omnicare, Inc.*, 757 F.3d at 503-507.

[31] *See Fait*, 655 F.3d at 112 n.5. The Second Circuit recently underscored the disconnect between ''subjective falsity'' and scienter in *Freidus v. Barclays Bank PLC*, No. 11-2665-cv, 2013 BL 218842, at *7-8 (2d Cir. Aug. 19, 2013), another Section 11/Section 12 case in which the Second Circuit applied *Fait* but also upheld a proposed complaint alleging that ''Barclays *knowingly* failed to properly write down its exposure' '' to CDOs and mortgage-backed securities [emphasis in Second Circuit opinion]. The court of appeals also noted that the complaint pleaded a factual basis for that conclusion. *Id. at *6 & n.4.*.

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be ''yes.'' A number of courts have recognized that the mental state needed to prove subjective falsity of an opinion statement is the speaker's *actual disbelief* in the opinion.[32] Stated another way, recklessness – held by all the federal courts of appeals, although not yet by the Supreme Court, to be a mental state sufficient to satisfy the scienter requirement for liability under Section 10(b) of the Exchange Act[33] – is insufficient to prove the subjective falsity of an opinion. An opinion that is ''recklessly'' held – so long as it is, in fact, held – is still the speaker's opinion, and his/her statement that it *is* his/her opinion is still a true statement.[34] Thus, the SEC's normal disjunctive mantra addressing scienter in Section 10(b)/Rule 10b-5 cases – that the defendant acted ''with knowledge or recklessness''[35] – would not adequately allege subjective falsity in any case involving a ''numerical opinion.''[36] Moreover, particularly in fraud cases it will not be enough for the SEC or a private plaintiff simply to include a boilerplate statement that the speaker of a ''numerical opinion'' did not believe it. Instead, in such cases the complaint must plead the facts that support subjective disbelief ''with particularity.''[37] In the absence of such facts, the complaint should be dismissed.

Thus, the legal ramifications of *Fait*, where it applies, are substantial for both the SEC and private plaintiffs.

C. Judicial Application of *Fait* to Financial Statement Numbers and Related Financial Concepts Other Than Goodwill and Loan Loss Reserves. From a factual point of view, *Fait*'s concept of ''numerical opinions'' has proved to be a fertile one. In addition to predictable cases within the Second Circuit that simply apply the holding of *Fait* to the very types of accounts that it considered,[38] courts both inside and outside the Second Circuit have applied *Fait*'s reasoning to a variety of other accounts whose value is determined, in whole or in part, by the exercise of management's judgment. These include:

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[32] *See In re Deutsche Bank AG Sec. Litig.*, No. 09 Civ. 1714(DAB), 2012 WL 3297730 at *2 (S.D.N.Y. Aug. 10, 2012); *Billhofer*, 2012 BL 192977, at *10 citing *In re Bank of Am. Corp. Sec., Deriv. & ERISA Litig.*, 757 F. Supp.2d 260, 310 & n.12 (S.D.N.Y. 2010) (collecting cases); *see also City of Omaha, Nebraska Civilian Emps. Ret. Sys.*, 679 F.3d at 68 (not discussing recklessness, but holding insufficient plaintiff's allegation that defendants should have commenced impairment testing sooner).

[33] *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309, 1323 (2011); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007).

[34] This is not to say that publishing ''recklessly held'' numerical opinions is in any way advisable for a public company. As discussed in Section II below, even when accounting rules commit a number to management's judgment, those rules typically provide steps by which the judgment should be reached. An issuer risks SEC enforcement action based on Section 13(b)(2)(A) or (B) of the Exchange Act relating to internal control and accounting records if it does not have adequate procedures to ensure that it complies with generally accepted accounting principles in the United States (''U.S. GAAP'') or its own procedures. Documenting the process followed by the decisionmakers whose ''numerical opinion'' is being reported is also important when the issuer is a collective entity with multiple officers and directors and questions arise over whose ''subjective disbelief'' matters: the opinions of the decisionmakers, or the opinions of the authors of the random e-mails that often surface when events prove a ''numerical opinion'' to be objectively incorrect.

[35] *See, e.g.*, Complaint in *SEC v. Vitesse Semiconductor Corp.*, No. 10 Civ. 9239, at 59 (S.D.N.Y. filed December 10, 2010), described in Accounting & Auditing Enforcement Release No. 3217 (Dec. 10, 2010). In *Freidus v. Barclays Bank PLC*, discussed in note 31 above, the proposed complaint that the Second Circuit held sufficient under *Fait* flatly alleged ''knowing'' and not ''reckless'' conduct.

[36] When recently put to the test on this issue in *SEC v. Goldstone*, No. CIV 12-0257 JB/LFG, 2013 BL 180973 (D.N.M. July 08, 2013), the SEC sidestepped it. One of the SEC's claims in *Goldstone* was that the defendants failed to classify some $400 million in adjustable rate mortgage securities as other than temporarily impaired (''OTTI'') in Thornburg Mortgage, Inc.'s 2007 Form 10-K filing. The SEC's complaint alleged that ''[b]ased on clear accounting guidance that [the former chief accounting officer] provided to [the former chief executive officer and the former chief financial officer], the Defendants . . . knew, or were reckless in not knowing, that, under these circumstances, the company was required to recognize an impairment in excess of $400 million of these assets on its income statement.'' Complaint in *SEC v. Goldstone*, ¶ 12, attached to Lit. Rel. No. 22287. When presented with the *Fait* argument in defendants' motions to dismiss, the SEC characterized its complaint as alleging that the defendants ''*did not believe* they had the ability to hold assets to recovery and thus *did not believe* those assets were only temporarily impaired.' '' 2013 BL 180973, at *124, quoting an SEC brief in the case [emphasis added]. The court denied defendants' motion to dismiss the OTTI claim, ruling that ''the SEC has sufficiently alleged that the Defendants plausibly did not believe the OTTI analysis in the 2007 Form 10-K.'' *Id.* at *184.

[37] *See* Fed.R.Civ.P. 9(b). In private accounting and disclosure cases brought under Section 10(b) of the Exchange Act and Rule 10b-5, the Private Securities Litigation Reform Act (''PSLRA'') added two additional ''particularity'' requirements. Section 21D(b)(1) of the Exchange Act, 15 U.S.C. § 78u-4(b)(1), requires that a private complaint alleging a false statement of material fact under that Act ''shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.'' Even more emphatically, Section 21D(b)(2) of the Exchange Act, 15 U.S.C. § 78u-4(b)(2), states that when a private claim under that Act requires proof that the defendant acted with a particular state of mind, the complaint must ''state with particularity facts giving rise to *a strong inference* that the defendant acted with the required state of mind'' (emphasis added). Although Section 21D(b)(2) typically is applied in the context of scienter, subjective falsity in an opinion-based case also would appear on its face to be ''a particular state of mind'' to which that section would extend.

If the plaintiff's claim is brought under a non-scienter-based statute, the complaint still must at least satisfy the *Twombly/Iqbal* standard, which requires that the plaintiff allege a ''plausible'' claim. *See Ashcroft v. Iqbal,* 556 U.S. 662, 678-80 (2009); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007). Under that standard, a purely conclusory statement that the defendant subjectively disbelieved a ''numerical opinion'' may not suffice. Moreover, some complaints, even if brought under non-scienter-based statutes, ''sound in fraud'' and are evaluated under the stricter Rule 9(b) standard. *See, e.g., Belmont Holdings Corp. v. SunTrust Banks, Inc.*, No,1:09-cv-1185-WSD (Consolidated), 2011 U.S. Dist. LEXIS 156309 at *25-*26, *35-*37 &n.10 (N.D. Ga. Sept. 7, 2011) (denying motion to dismiss but focusing discovery on ''subjective falsity''); *Belmont Holdings Corp. v. SunTrust Banks, Inc.*, 896 F. Supp.2d 1210, 1228 (N.D. Ga. 2012) (dismissing case).

[38] *See, e.g.*, *City of Omaha, Neb. Civilian Employees' Ret. Sys.*, 679 F.3d at 67 (goodwill impairment); *Levy v. Huszagh*, No. 11-CV-3321 (JS)(GRB), 2012 WL 4512038 (E.D.N.Y. Sept. 28, 2012) (loan loss reserves).

■ ''Incurred but not reported'' reserves, which capture potential payments of future insurance claims;[39]

■ The valuation of real estate investment trust shares not traded on an exchange;[40]

■ Valuations of collateralized mortgage obligations and mortgage-backed securities, along with related statements regarding the other-than-temporary impairment status of securities;[41]

■ Valuations of collateralized debt obligations and residential mortgage-backed securities;[42]

■ The appraised value of real estate;[43]

■ The carrying value of a geothermal generation plant (against a claim that the defendant should have recognized an impairment of that asset);[44]

■ Disclosures regarding ''significant concentrations'' of credit risk under Statement of Financial Accounting Standards (''FAS'') 107;[45] and

■ Disclosures regarding whether a contract represents a ''guarantee'' for purposes of FASB Interpretation 45.[46]

Courts have also applied *Fait* to textual disclosures *about* financial statement numbers or concepts, such as:

■ Statements about the adequacy of an insurer's capitalization that were based, in turn, on the insurer's valuation of its assets;[47]

■ Statements regarding portfolio risk that were based on the corporate defendant's valuations of its securitized portfolio;[48]

■ Statements in offering materials attributed to appraisers regarding loan-to-value ratios;[49]

■ Statements in offering documents that a source of financing is reliable.[50]

The above examples show the factual sweep of *Fait's* recognition of ''numerical opinions.'' based on cases decided to date. As we will see in Section II below, *Fait's* potential application to financial statements is broader still.

II. If *Fait* Continues to Hold Sway, How Much of the Law of Liability for 'Bad Numbers' Will It Swallow Up?

Both before and after *Fait*, of course, certain parts of financial statements are purely factual, and are not opinions in any sense. For example, the book value of a desk when it was acquired in 2002 is not an opinion. However, taking the decision in *Fait* to its logical conclusion, the many estimates, judgments and opinions required to be made under generally accepted accounting principles in the United States (''U.S. GAAP'') could be treated differently for liability purposes. Thus, the fair value of that same desk in 2013 – absent a market

[39] *City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.*, No. 12 Civ. 0256 (LAK), 2013 BL 54028, at *7 (S.D.N.Y. Feb. 28, 2013) (''While these estimates involve some factual inputs, they necessarily require judgment.'') (note, however, that court found amended complaint ''sufficient to plead that MetLife either did not believe the accuracy of its statements or actually knew that there was no reasonable basis for its estimates, which amounts to much the same thing.'' *Id.* at *7-*8).

[40] *In re Apple REITs Litig.*, No. 11-CV-2919 (KAM), 2013 BL 92404, at *13 (E.D.N.Y. Apr. 03, 2013) (''Plaintiffs claim that the REITs' disclosure in its offering documents that the $11 per share prices have been established arbitrarily by us and may not reflect the true value of the Units,. . . was false and misleading because in fact defendants chose and maintained an $11 share price to compete with other non-traded REITs, nearly all of which sold for $10' ''; court finds the REITs' valuation not misleading because the inherent difficulties in determining the value of REIT shares mean that valuations can only fairly be characterized as subjective opinions).

[41] *MHC Mut. Conversion Fund, L.P. v. United W. Bancorp, Inc.*, 913 F. Supp. 2d 1026 (D. Colo. 2012) [2012 BL 387633, at *9-11] (dismissing despite allegations that regulators had criticized the bank's methodology for determining when CMOs and MBS were other-than-temporarily-impaired); *but see SEC v. Goldstone*, discussed in note 35 above.

[42] *Freidus v. Barclays Bank PLC*, discussed in note 31 above (Second Circuit holding that valuations of CDOs and MBS fall within *Fait*, but finding that proposed complaint adequately alleged subjective falsity); *NECA-IBEW Pension Trust Fund v. Bank of Am. Corp.*, No. 10 Civ. 440 (LAK)(HBP), 2013 BL 41109, at *16 (S.D.N.Y. Feb. 15, 2013) (''Allegations of 'garden-variety mismanagement, such as managers failing to . . . adequately inform themselves do not state a claim under the federal securities laws.''); *In re Deutsche Bank AG Sec. Litig.*, 2012 WL 3297730 (dismissing complaint); *but see IBEW Local 90 Pension Fund v. Deutsche Bank AG*, No. 11 Civ. 4209 (KBF), 2013 BL 80646, at *15 (S.D.N.Y. Mar. 27, 2013) (declining to dismiss complaint based on plaintiff's having pleaded ''facts supportive of both objective and subjective falsity'').

[43] *Am. Int'l Group, Inc. v. Bank of America Corp.*, Nos. 2:11–ML–02265–MRP (MANx), 2:11–CV–10549 MRP (MANx), 2013 WL 1881567, at *15 (C.D. Cal. May 6, 2013).

[44] *Bartesch v. Cook*, Civil Action No. 11-1173-RGA, 2013 BL 107722, at *6-*7 (D. Del. Apr. 23, 2013).

[45] *In re Am. Int'l Grp., Inc., 2008 Sec. Litig.*, ., No. 08 Civ. 4772 (LTS)(DCF), 2013 BL 112330, at *4-*5 (S.D.N.Y. Apr. 26, 2013), citing *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 291 (S.D.N.Y.2011). FAS 107 is codified in Topic 825 of the FASB Accounting Standards Codification (''FASB ASC'') Topic 825.

[46] *In re Am. Int'l Grp., Inc., 2008 Sec. Litig.*,), 2013 BL 112330, at *5. FIN 45 is codified in FASB ASC Topic 460.

[47] *City of Monroe Employees' Ret. Sys. v. Hartford Financial Services Group, Inc.,* 2011 BL 238186.

[48] *Lighthouse Fin. Grp. v. Royal Bank of Scotland Grp., PLC*, 902 F. Supp. 2d 329, 345 (S.D.N.Y. 2012) (court finds ''neither false nor actionable'' plaintiffs' allegation that financial statements misled Exchange Offer participants as to the nature and extent of RBS's subprime holdings because they represented that RBS had a ''traditional unwillingness to engage in subprime lending'' and that ''portfolio risk remained stable and the corporate credit environment remained benign.''); *but see Fed. Hous. Fin. Agency v. SG Americas, Inc.*, No. 11 Civ. 6203 (DLC), 2012 BL 309466, at *2 (S.D.N.Y. Nov. 27, 2012) (finding that statements about underwriting criteria concern a matter of objective fact, and are not statements of opinion; thus, *Fait* has ''limited relevance'' and the court does not apply it).

[49] *UBS Americas, Inc.*, 858 F. Supp 2d at 324; *SG Americas, Inc.*, 2012 WL 5931878, at *3 (court agrees that ''where the expressed belief is about a matter that is one of opinion or a subjective fact, then the Securities Act plaintiff must plead more, as this Court explained recently in applying *Fait*. . . . For that reason, to challenge the defendants' statements regarding LTV, the plaintiff must attack the first component of the statement: that the person to whom the belief is ascribed—the appraiser—holds the belief stated.'').

[50] *In re Gen. Elec. Co. Sec. Litig.*, 856 F. Supp. 2d at 657.

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quote for such desks – likely is an estimate, judgment or opinion.

This section analyzes *Fait* as it relates to a company's financial statements by (i) discussing the accelerating trend in U.S. GAAP requiring managements to reach opinions, make judgments and prepare estimates that are then reflected in published financial statements, (ii) describing examples of judgments, opinions and estimates under U.S. GAAP, and (iii) identifying some of the litigation issues that stem from the application of *Fait* to financial statements.

A. Trends in U.S. GAAP Requirements. U.S. GAAP has traditionally required management to make judgment calls in preparing financial statements. A classic example is loss contingencies. The accounting for loss contingencies depends upon whether management believes that it is probable that the loss contingency will result in liability and, if so, whether the amount is reasonably estimable.[51] Loss contingencies include pending or threatened litigation, collectibility of receivables and loans, injuries or damage caused by products sold, risk of loss or damage of property by fire, explosion or other hazards and actual or possible claims and assessments. Thus, a contingency involves both judgments and estimates about the loss contingency, which are subject to material changes over time as new information becomes available and previous judgments are confirmed or revised.

While U.S. GAAP has traditionally required managements to make judgments and prepare estimates, the trend is toward requiring more of them.[52] For example, the FASB's focus on fair value accounting during the last ten years has resulted in additional guidance on the measurement of fair value and additional disclosure about the fair values of assets and liabilities, which has increased the requirement for managements to make judgments. In addition, as a result of the increasing complexity of accounting standards, the FASB has begun to require additional narrative disclosures about the judgments and estimates required by those standards. Given the increasing complexity of transactions, business enterprises and regulation, as well as the internationalization of business, the trend of U.S. GAAP to require estimates, judgments and opinions to be reflected in the financial statements is unlikely to abate in the future.

B. Judgments Reflected in Financial Statements. U.S. GAAP that requires management to estimate and make judgments include the principles applicable to the valuation of assets, including receivables, inventory, investments, and property, plant and equipment, the assessment of liabilities, including defined benefit plans, environmental obligations, contingent liabilities, including guarantees, warranties, and income taxes, and the recognition of revenue, including on long-term contracts. Thus,

- Receivables may be in the form of loans, notes and other types of financial instruments. A valuation allowance for losses related to receivables should be recorded if the loss is probable and the amount of the loss is reasonably estimable,[53] both of which require management judgments.

- Inventory obsolescence can occur when there is decreased demand during an economic downturn, such as occurred during the Great Recession, as well as because of technological innovation, among other reasons. Thus, judgment is required when management is estimating an allowance for obsolete inventory.

- Investments are classified as trading, available for sale or held to maturity depending upon whether the entity intends to sell the investment within hours or days or hold the investment for a period of time. Held-to-maturity investments are those that the entity has the positive intent and ability to hold to maturity. Judgment is necessary to determine the classification and to determine when investment securities that are not classified as trading securities must be written down because of an impairment in value.[54]

- The cost of assets, such as property, plant and equipment[55] and intangible assets, such as patents, trademarks and customer lists, is recognized in the financial statements over the estimated useful life of the asset.[56] The determination of the appropriate useful life often requires the exercise of management judgment. The value of goodwill is assessed every year and more frequently when there are indicia of an impairment.[57]

- The accounting for obligations related to a defined benefit pension plan requires a calculation of net periodic costs for a specified period that is then charged to income.[58] The net periodic cost is estimated at the beginning of an accounting period based on actuarial assumptions, which amount and assumptions are subject to change in subsequent periods.

- Compliance with environmental laws and regulations, at the international, federal, state and local level, can require the accrual of remediation liabilities, which in turn can include direct costs as well as estimates of future costs, such as compensation costs and benefits to employees.[59] Measurement of the liability can include estimating the cost to perform all the efforts needed for remediation.

- Product warranties and other guarantee contracts are updated in each reporting period to reflect payment

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[51] ASC Topic 450 (Loss Contingencies).

[52] In this regard, the SEC's Advisory Committee on Improvements to Financial Reporting noted the following: "The preparation and audit of financial statements have always required the exercise of judgment. The recent trend in accounting entails a move away from prescriptive guidance toward greater use of judgment – for example, the more frequent use of fair value involves estimates of value that may be less objectively determined than historical cost measures. Similarly, the revised auditing standard applicable to audits of internal control over financial reporting, issued by the PCAOB last year, emphasizes the need for professional judgment in taking a risk-based approach to performing internal control audits. *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission*, at 7 (Aug. 1, 2008)

[53] ASC Topic 310-10-35 (Receivables).

[54] ASC Topic 320-10-35 (Investments – Debt and Equity Securities); ASC Topic 350.

[55] ASC Topic 360 (Property, Plant and Equipment).

[56] ASC Topic 350 (Intangibles – Goodwill and Other).

[57] ASC Topic 350-20-35.

[58] ASC Topic 715 (Compensation – Retirement Benefits).

[59] ASC Topic 410 (Asset Retirement and Environmental Obligations).

reductions, new issuances and changes to preexisting warranties.[60] Judgment is required in revising these amounts to reflect such matters as estimating future product failure.

■ A deferred tax liability or deferred tax asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences or carry-forwards at the end of the current period.[61] Estimating the future tax effects of deferred tax liabilities or assets, especially in a period when future taxable income or corporate tax rates are uncertain, requires the exercise of management judgment. A tax position is recognized when it is more likely than not that the position will be upheld upon examination. Judgment is required to evaluate the merits of the tax position and measure the amount of benefit from the tax position that can be recognized in the financial statements.[62]

■ Since long term contacts typically involve uncompleted transactions or future uncertainties,[63] judgment is required in estimating the effect of future purchases or cost-of-completion.

The U.S. GAAP discussed above requires the exercise of judgment, which can involve consideration of a range of alternative outcomes and can be subject to material change. The Great Recession showed that fair value accounting, adopted before the downturn in 2007, may be the ultimate example of how the decision in *Fait* may be applicable in the future. U.S. GAAP[64] establishes a three-level hierarchy for the classification of inputs used to determine the fair value of assets and liabilities based on the degree of objectivity and reliability of the inputs. Level 1 inputs are unadjusted quoted prices in active markets for identical assets and liabilities. Since levels 2 and 3 use inputs that are more subjective, they require more judgment in identifying the appropriate inputs used in the measurement calculation, which typically can include identifying and then estimating the price of a similar asset or identifying unobservable inputs to be used in a valuation technique. The lack of reliable quoted prices at level 1 during the Great Recession led to a new and expanded role for the estimation process in fair value accounting, initially at level 2 but then, as markets became illiquid, at level 3. It is one thing to estimate the fair value of a privately traded derivative by a comparison with an existing trading market, and quite another to do so in an illiquid market where there is a wide divergence of opinion as to value among experienced and otherwise reasonable people in the marketplace. Nonetheless, fair value accounting is here to stay. Given the increased development of financial instruments over the past decade, fair value accounting has expanded to follow new and different instruments, which include, but are not limited to: trading securities; available-for-sale debt securities, such as bonds and collateralized debt obligations; available-for-sale equity; hedge fund investments; derivatives; and long-lived assets held and used or held for sale.

In addition to specifically *requiring* management to estimate an amount or make a judgment in certain areas, U.S. GAAP specifically *permits* management to make a judgment when the applicable U.S. GAAP does not address the situation. Under U.S. GAAP, entities should account for a transaction or event according to authoritative U.S. GAAP.[65] However, ''[i]f the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider non-authoritative guidance from other sources,''[66] which could require management to make a judgment. U.S. GAAP also requires disclosure to accompany management's estimates when it is at least reasonably possible that there could be a material change to the financial statements in the near term as a result of future changes.[67]

The FASB is also continuing to propose and adopt standards that involve management making judgments that are reflected or disclosed in the financial statements. Most recently, the FASB proposed an exposure draft concerning uncertainties relating to a going concern. If this draft is adopted as proposed, an entity would be required to provide footnote disclosure on a quarterly basis when it is more likely than not that the entity will not be able to meet its obligations within 12 months or it is known or probable that the entity will be unable to do so within 24 months after the date of the financial statements without taking actions outside the ordinary course of business.[68] The proposal would require an evaluation and judgments by management along with forward-looking statements about the future prospects of an entity.[69]

C. Litigation Challenges. The foregoing survey of the accounting literature does not, of course, demonstrate that all numbers in financial statements are ''numerical opinions'' under *Fait*. As illustrated by the simple example of the book value of a desk on its acquisition with which we began this section, some statements simply are facts. Moreover, even where judgments are in-

[60] ASC Topic 460 (Guarantees).

[61] ASC Topic 740 (Income Taxes).

[62] *Id.*

[63] ASC Topic 605-35 (Revenue Recognition – Construction-Type and Production-Type Contracts). The FASB and the International Accounting Standards Board have been working on a new revenue recognition standard that is expected to become final later this year. This standard will further increase the need for judgment and estimates in various areas including the determination of a stand-alone selling price, the determination whether the arrangement with collaborators and partners is within the standard, the impact on the accounting treatment of a contract modification, variable consideration, and price concessions, and the evaluation whether a long-term arrangement or an arrangement involving various services or goods involves a financing component. FASB, Proposed Accounting Standards Update (Revised) – Revenue Recognition (Topic 605); Revenue from Contracts with Customers (including proposed amendments to the FASB Accounting Standards Codification,'' File Reference No. 2011-230 (June 24, 2010).

[64] ASC Topic 820 (Fair Value Measurement).

[65] ASC Topic 105-10-05-1 (General Principles).

[66] ASC Topic 105-10-05-2 (General Principles).

[67] ASC Topic 275-10-50-6 (Risks and Uncertainties).

[68] FASB, *Proposed Accounting Standards Update - Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Going Concern Presumption*, at paragraph 205-40-50-3, File Reference No. 2013-300 (June 26, 2013).

[69] The safe harbor protection for forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 does not apply to the financial statements, including the notes thereto.

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volved, *Fait* does not immunize those judgments. Reasons, opinions or beliefs ''may be actionable if they misstate the opinions or belief held or in the case of statements of reasons, the actual motivation for the speaker's actions, *and* are false or misleading with respect to the underlying subject matter they address.''[70] Simply put, liability can still be found if a ''numerical opinion'' was ''both objectively false and disbelieved by the defendant at the time it was expressed.''[71]

How can a plaintiff show that the accounting was subjectively false? In light of *Fait*, to avoid losing a summary judgment motion by the defendant company, a plaintiff must show that: (1) U.S. GAAP did not provide for or by analogy allow the company to make an estimate or judgment with respect to the transaction or event; or (2) the company did not actually believe the estimate, judgment or opinion at the time it was made and/or disclosed. As support for a claim that a company did not actually believe the estimate, judgment or opinion, a plaintiff might show that the company did not actually follow the process that it had developed for the preparation of the estimate, judgment or opinion or that the company's disclosure of that process did not accurately reflect the process that management actually followed.

Fait states that the complaint must plausibly allege that the defendants in fact did not believe the opinion when it was expressed. Accordingly, a plaintiff can limit the protections of *Fait* by providing evidence that management and/or the individual directors on the audit committee or the board of directors or its audit committee did not believe the estimate or the opinion reached. Thus, emails, which have become the object of many document requests, would appear to be a fruitful area for plaintiffs seeking to limit the scope of *Fait*.[72]

Merely alleging that an estimate, judgment or opinion was not consistent with applicable GAAP is not enough under *Fait*. A plaintiff must plausibly adduce facts that suggest that the defendant did not, in fact, believe the estimate, judgment or opinion to satisfy the requirement for a plausible allegation of subjective falsity. If the plaintiff prevails on a motion to dismiss, the defendants could still present accounting experts at trial to demonstrate that an estimate, judgment or opinion was not subjectively false, and the judgment calls required by U.S. GAAP could result in differing opinions from accounting experts.

III. SEC and Plaintiffs' Reactions to *Fait*

As we suggested above, a possible response to *Fait* by the SEC is to focus less on the numbers in financial statements—many of which will be ''numerical opinions''—and concentrate on the processes by which those numbers were derived. If *Fait* limits the ability of the SEC and private plaintiffs to question opinions in SEC filings, the SEC and private plaintiffs also may increasingly question the adequacy of companies' disclosures in the MD&A.

A. Capital One and Disclosure Controls and Procedures. Last spring the SEC brought a cease and desist proceeding that illustrates the continuing liability that companies face for ''numerical opinions'' despite *Fait*.[73] The SEC alleged in its cease and desist proceeding pursuant to Section 21C of the Exchange Act against Capital One Financial Corp. (''Capital One'') and two of its officers that the loss reserves that Capital One reflected for its auto financing business were understated in Capital One's quarterly reports on Form 10-Q for the periods ended June 30, 2007 and September 30, 2007. Because *Capital One* was a settled case, the SEC was not obliged to—and did not—address *Fait* or any other precedent, even though *Fait* would, presumably, protect a company from liability related to its estimate of a reserve, assuming that the estimate was believed by the relevant decisionmakers.

Although the *Capital One* litigation release announcing the settlement did not address *Fait*, the SEC may have taken *Fait* into account indirectly given its focus on the procedures by which Capital One arrived at its loan loss reserves. The SEC's release noted that, in calculating the reserve for the auto financing business, Capital One failed to: (a) comply fully with its policies and procedures related to the forecasting of losses; (b) document the reasons for not taking into account certain loss factors required to be considered by the applicable loss model; (c) take into account risks in the forecasting process identified by Capital One's internal audit department; (d) fully report the inadequate loss-reserve process to Capital One's allowance committee, which had a primary internal control function over the allowance-setting function; and (e) implement a system for Capital One's accounting group to monitor the auto financing business loss reserve forecasting process. In addition, the SEC described various e-mails relating to the need for the incorporation of the omitted loss factors to avoid an insufficient allowance. The SEC alleged that, if Capital One had fully reflected the omitted loss factors in its forecasting process, its net income for the second and third quarters of 2007 would have been reduced by 7 percent and 41 percent, respectively. Accordingly, the SEC ordered Capital One and two of its officers[74] to cease and desist from violating Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. Capital One agreed to pay a civil penalty in the amount of $3.5 million and the two officers agreed to pay $85,000 and $50,000, respectively.

Capital One is instructive as to the risks of SEC enforcement action with respect to a numerical opinion. At least in the context of an SEC enforcement action, a company that fails to comply with its own policies, procedures, and controls in developing a numerical opinion or to fully document the reasons for such failures, or that has internal e-mails that question the company's

[70] *Fait*, 655 F.3d at 111, citing *Va. Bankshares,* 501 U.S. at 1091-96.

[71] *Fait*, 655 F.3d at 110, citing *Va. Bankshares*, 501 U.S. at 1095-96.

[72] In many ways, the SEC will have an easier time dealing with *Fait* than will private plaintiffs, because the SEC is empowered to conduct a compulsory pre-complaint investigation, which may turn up e-mails or other evidence that the ''numerical opinions'' that appear in financial statements were, in fact, disbelieved by those who published them.

[73] *In the Matter of Capital One Fin. Corp.,* Exchange Act Rel. No. 69442 (April 24, 2013).

[74] The officers were the chief risk officer of Capital One, who was responsible for, among other things, making recommendations to Capital One's accounting group with respect to the loan loss allowance, and the divisional credit officer for the auto finance business, who was responsible for managing the division's loss-forecasting function.

final numerical opinions or the process by which they were derived, may risk an enforcement action under Section 13(b)(2)(A) and (B).[75]

Another recent SEC case emphasizes management's failure to comply with required procedures in reaching opinions. The Commission noted in the litigation release announcing the settlement of an action against Anchor Bancorp Wisconsin, Inc. and its former chief financial officer that the company's former chief financial officer intentionally took actions to avoid having to correct the company's earnings results that had already been made public.[76] The SEC's complaint alleged that the chief financial officer revised the company's methodology for estimating the reserve for ''substandard not reviewed'' loans to offset an accounting adjustment required by the auditor's identification, after the company had issued its earnings release, of the company's failure to update the loss factors for estimating unrelated reserves. In addition, the complaint alleged that the chief financial officer failed to take into account appraisals and other related information that were available after the earnings release but before the quarterly report on Form 10-Q was filed. The chief financial officer asserted that the company did not need to consider the appraisals and other information because they were received after the earnings were released, and signed a representation letter provided to the auditor in which he asserted that the loan loss reserves were adequate. The SEC's complaint noted that the company's internal control over financial reporting, which was subject to the chief financial officer's responsibility, should have provided reasonable assurance that subsequent events would be taken into account up until the date the Form 10-Q is filed, as required by U.S. GAAP.

B. Management's Discussion and Analysis. Another process-related response to *Fait* rests on the fact that estimates, judgments and opinions may be based, at least in part, on matters required to be disclosed in the MD&A, such as known trends, demands, commitments events or uncertainties (collectively, ''trends and uncertainties''), including critical accounting policies. Although these estimates, judgments and opinions may be protected by *Fait*, a company and its officers may risk liability under Sections 11 and 12(a)(2) of the Securities Act if the company does not comply with the requirements applicable to the MD&A. Courts have held that a failure to comply with Item 303 of Regulation S-K gives rise to liability under Sections 11 and 12(a)(2).[77] In addition, the SEC can bring cease and desist actions for failure to comply with Item 303 of Regulation S-K.[78] In contrast, courts have held that a violation of Item 303 does not automatically give rise to a material omission under Rule 10b-5 under the Exchange Act because Rule 10b-5 requires a demonstration of a separate duty to disclose the information.[79]

The Staff of the SEC's Division of Corporation Finance has increasingly been issuing comments asking for disclosure about known trends and uncertainties in the MD&A. Based on the Staff's review of the risk factors or other disclosures in a document or the transcripts of earnings calls, analyst reports or other publicly available information about a company, the Staff has asked a company to revise the MD&A or describe in future MD&As the impact of trends or uncertainties identified by the company on future results.

Since 1980, section (a)(1) of Item 303 of Regulation S-K has required companies to describe ''known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in a material way'' in their MD&A discussion about liquidity and capital resources.[80] Item 303(a)(2)(ii) requires a description of ''any known material trends, favorable or unfavorable, in the registrant's capital resources.'' In addition, Item 303(a)(3)(ii) requires the MD&A discussion about results of operations to address, among other things, ''any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.''

The SEC has required trend and uncertainty disclosure because of the three principal objectives of the MD&A. These objectives are to ''[enable] investors to see the company through the eyes of management,'' ''enhance the overall financial disclosure and provide the context within which financial information should be analyzed,'' and ''provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future per-

[75] To settle a case with the SEC, a company may also have to agree to an action under other federal securities law sections, such as Section 13(a), to which Capital One and its two officers also agreed.

[76] *Commission Charges Anchor Bancorp Wisconsin and Former CFO with Fraud,* Lit. Rel. 22778 (Aug. 14, 2013). In the proposed settlement (still subject to court approval as of August 2013), the company agreed to a final judgment permanently enjoining it from violating Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5 and 13a-13 thereunder. The chief financial officer agreed to a permanent injunction from violating Section 10(b) under the Exchange Act and Rules 10b-5, 13a-14, 13b2-1 and 13b2-2(a) thereunder and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rule 13a-13 thereunder. In addition, the chief financial officer agreed to pay a penalty of $57,000 and to a bar from serving as an officer or director of a public company for five years.

[77] *See, e.g., Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir 1998).

[78] *See, e.g., In the Matter of Tidewater Inc. & James Keith Lousteau, CPA*, Securities Exchange Act Release No. 56557 (Sept. 27, 2007); *In the Matter of Presstek, Inc.*, Securities Exchange Act Release Nol 39472 (Dec. 22, 1997).

[79] *See, e.g., Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991) (with respect to allegations that, among other things, Pyramid Technology violated Item 303 because it did not disclose delays in the introduction of a new family of products that was expected to account for significant profits, was requiring significant additional expenditures and was reducing sales while customers waited for the new products, the court stated that ''demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5'').

[80] Securities Act Rel. No. 6231, *Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure System* (45 Fed. Reg. 63,630, Sept. 2, 1980).

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formance."[81] In this regard, Instruction 3 to Item 303 provides as follows:

> The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations.[82]

Section 9220.11 of the SEC Division of Corporation Finance Financial Reporting Manual states that "reasonably likely" for purposes of the assessment of the need for known trend and uncertainty disclosure "is a lower threshold than 'more likely that not' but a higher threshold than 'remote.' " In addition, Section 9220.11 explains that the "reasonably likely" standard is not intended to "mirror" the "reasonably likely" threshold for disclosure about loss contingencies required by generally accepted accounting principles in the U.S.[83] "More likely than not" is generally understood to mean greater than 50 percent[84] and remote is generally understood, at least for purposes of the recognition and disclosure of loss contingencies, to mean extremely doubtful or slight.[85]

The SEC has explained the analysis for disclosure about a known trend or uncertainty as follows:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
>
> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[86]

The Staff of the SEC's Division of Corporation Finance is not alone in focusing on known trend or uncertainty disclosure. Both the SEC's Division of Enforcement and private plaintiffs are paying increasing attention to the topic, and federal courts—notably, but not exclusively, courts in the Second Circuit—have increasingly denied defendants' motions to dismiss claims under Sections 11 and 12(a)(2) relating to non-compliance with the requirement in Item 303 of Regulation S-K that the MD&A describe any material known trends and uncertainties.

Prior to 2011, private plaintiffs' efforts to base liability under Section 11 or 12(a)(2) of the Securities Act on a failure to comply with the SEC's requirement for trend and uncertainty disclosure failed because the trend was knowable but not known,[87] or the allegations failed to raise a factual question of whether management unreasonably failed to predict that the trend would materially affect its future earnings and profits,[88] or the omissions were protected by the "bespeaks caution" doctrine,[89] or a trend was not shown.[90] *Litwin v. Blackstone*[91] appears to be the first case in which the court ruled favorably for plaintiffs on a defense motion to dismiss, and is the case that recent courts have cited for support of their conclusion that plaintiffs had plausibly alleged a failure to comply with the Item 303 requirement for trend and uncertainty disclosure.

In *Litwin*, the Second Circuit held that the lower court had erred in dismissing the plaintiff's complaint brought pursuant to Sections 11, 12(a)(2) and 15 of the Securities Act because the plaintiffs had plausibly alleged that Blackstone had omitted from its registration statement for its initial public offering in 2007 information that was required to be disclosed by Item 303 of Regulation S-K about known trends and uncertainties. The plaintiffs had alleged that Blackstone should have disclosed in its registration statement problems being experienced by two of its portfolio companies as well as its real estate fund investments because Blackstone allegedly knew of these problems, and reasonably expected that these problems would subject Blackstone to a claw-back of performance fees and reduced performance fees, which would materially reduce its future revenues. One of the portfolio companies insured collateralized debt obligations backed by sub-prime mortgages and the other one had publicly disclosed the loss of an exclusive contract. Although the portfolio companies represented less than 5 percent of Blackstone's total assets under management, the Second Circuit con-

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[81] Securities Act Rel. No. 8350, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (Dec. 19, 2003) ("SEC Interpretive Release"), referencing Securities Act Rel. No. 8056, *Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations* (Jan. 22, 2002) ("January 2002 Release").

[82] 17 C.F.R § 229.303, Instruction 3.

[83] The FASB defines "reasonably likely" in the FASB Accounting Standards Codification ("ASC") Part 450-20 as "[t]he chance of the future event or events occurring is more than remote but less than likely."

[84] *E.g.*, FASB ASC Part 350-20-35-3A (relating to the measurement of goodwill); FASB ASC Part 740-10-25-6 (relating to the recognition of a tax position).

[85] American Bar Association, Audit Responses Committee, *Auditor's Letter Handbook*, 31 Business Lawyer 1709, 1713 (April 1976) ("an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight"); FASB ASC Part 450-20 defines "remote" as "[t]he chance of the future event or events occurring is slight."

[86] Securities Act Release No. 6835, *Interpretive Release: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures* (May 18, 1989).

[87] *See, e.g., J & R Marketing, SEP v. Gen. Motors Corp.*, 549 F.3d 384, 391-92 (6th Cir. 2008).

[88] *See, e.g., Steckman*, 143 F.3d at 1296; *In re Sofamor Danek Grp., Inc.*, 123 F.3d 394, 402 (6th Cir. 1997) (holding that the defendant "could have had no way of knowing with the degree of assurance [required by Item 303 of Regulation S-K] that the merchandising practices in question would have a material adverse impact upon future operating results").

[89] *See, e.g., In re Initial Pub. Offering Secs. Litig.*, 358 F. Supp. 2d 189, 212 (S.D.N.Y. 2004) (dismissing the alleged omission of information about the downward trend in advertising rates because the prospectus warned about lower advertising rates in the future).

[90] *See, e.g., Oxford Asset Mgmt., Ltd. v. Jaharis*, 297 F.3d 1182, 1190-92 (11th Cir. 2002) (first six weeks' prescription volume estimates need not be disclosed).

[91] 634 F.3d 706 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 242 (2011).

sidered the qualitative factors identified by the SEC Staff in Staff Accounting Bulletin No. 99 (1999)[92] and held that the plaintiffs had adequately pleaded that Blackstone had omitted material information about those portfolio companies required to be disclosed by Item 303. The Second Circuit noted that the portfolio companies were reflected in Blackstone's Corporate Private Equity fund segment, which played an important role in its business and provided value to all of its other asset management and financial advisory services, and a loss in connection with those investments was reasonably likely to have a material effect on the revenues of that segment.[93]

The Second Circuit also concluded that the plaintiffs had adequately pleaded that Blackstone had omitted material information about the manner in which its real estate investments might be materially affected by the then-existing downward trend in housing prices, the increasing default rates for sub-prime mortgage loans, and the pending problems for complex mortgage securities. The opinion noted that the real estate segment constituted 22.6 percent of Blackstone's total assets under management, and that the alleged misstatements and omissions were qualitatively material because they masked a potential change in earnings or other trends. The court of appeals also observed that the alleged omissions related to the portfolio companies and the real estate investments, if proven, had the effect of increasing management's compensation.

The Second Circuit focused on the particular investments that plaintiffs alleged should have been discussed in the MD&A because the known trends affecting those investments were reasonably likely to have a material effect on Blackstone's Corporate Private Equity segment. The Second Circuit rejected the defense that the trend or uncertainty was public knowledge, noting that the plaintiffs were alleging that ''Blackstone was required to disclose the manner in which [those then-known trends, events, or uncertainties] might reasonably be expected to materially impact Blackstone's future revenues.''[94] The court did not address whether its conclusion would have been different if Blackstone had disclosed its view of a known uncertainty in the MD&A, such as, that Blackstone did not believe that the deterioration of property values or the portfolio company's loss of the exclusive contract would adversely affect its financial statements or prospects. Such opinions, if held by the decisionmaker, should be protected by the *Fait* and *Va. Bankshares* standard.

Since *Litwin*, the Second Circuit and other courts have been willing to deny defendants' motions to dismiss claims based on nondisclosure of a known trend and uncertainty when the court concluded that the plaintiff had plausibly alleged that the known trend or uncertainty was reasonably likely to have a material impact on the registrant's liquidity, capital resources, net sales or revenues or income from continuing operations. In *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*,[95] the Second Circuit took the position, in a case alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act, that the plaintiff's complaint stated a claim because it plausibly alleged that defects in Ikanos Communications' semiconductor chips constituted a known trend or uncertainty that the Company reasonably expected would have a material unfavorable impact on revenues, and the Company had not disclosed any information about the particular defects that its customers had brought to its attention. In 2005, Ikanos had sold VDSL Version Four chips to Sumitomo Electric and NEC, its two largest customers that accounted for 72 percent of its 2005 revenues. In January 2006, Ikanos learned that there were quality issues in the chips that it traced to a third-party assembling company in China. Thereafter and during the weeks leading up to its March 2006 common stock offering, Ikanos received an increasing number of complaints from its two largest customers about the defects. The complaint further alleged that Ikanos's Board met and discussed the defect, and management travelled to Japan to meet with its customers to discuss the problem.

Ikanos did not include any disclosure in the registration statement and prospectus for the common stock offering about the defect, although the registration statement and prospectus did include a risk factor about possible defects. During the second quarter, after completion of the offering, Ikanos agreed to recall all of the chips sold to the two customers, reporting a net loss of $2.2 million for the quarter. Ikanos's stock price thereafter dropped from the offering price of $20.75 per share to $7.76 in response to various announcements about decreasing revenues.

The district court dismissed the first amended complaint and denied the plaintiff's motion for reconsideration and for leave to file a first proposed second amended complaint because of its view that neither complaint presented plausible allegations that '' 'Ikanos knew or should have known of the scope or magnitude of the defect problem at the time of the Secondary Offering.' ''[96] The Second Circuit affirmed the district court's dismissal of Panther's first amended complaint but vacated the district court's denial of Panther's motion for reconsideration and for leave to file the first proposed second amended complaint because the Second Circuit believed that Panther might be able to allege sufficient facts. On remand, the district court denied Panther's motion for leave to file a second proposed second amended complaint, concluding that the additional facts about the increasing number of complaints made by Ikanos's two largest customers during the weeks before the offering failed to demonstrate that the defect rate was above average.

The Second Circuit vacated the district court's decision and remanded the case with instructions to grant Panther leave to file the second proposed second amended complaint. The Second Circuit concluded that

[92] The consistency of SAB 99 with legal principles has been settled for quite some time. *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163 (2d Cir. 2000) (''SAB No. 99 is thoroughly reasoned and consistent with existing law – its non-exhaustive list of factors is simply an application of the well-established *Basic* analysis to misrepresentations of financial results – we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation'').

[93] Similarly, the Second Circuit noted in *Freidus v. Barclays Bank PLC,* discussed *supra* note 31, at *5 that ''[i]n a quickly deteriorating credit market, we believe the particulars about a firm's exposure to that market could assume a level of importance, and thus materiality, that may not have been the case in less economically stressful times.''

[94] *Litwin*, 634 F.3d at 719.

[95] 681 F.3d 114 (2d Cir. 2012).

[96] 681 F.3d at 118, quoting *Panther Partners, Inc. v. Ikanos Commc'ns, Inc.*, 538 F. Supp.2d 662, 673 (S.D.N.Y. 2008).

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the new allegations in the second proposed second amended complaint plausibly alleged ''that the defect issue, and its potential impact on Ikanos's business, constituted a known trend or uncertainty that Ikanos reasonably expected would have a material unfavorable impact on revenues or income from continuing operations.''[97] The new allegations were that two customers that were making the complaints about defects accounted for 72 percent of Ikanos's revenues in 2005 and that Ikanos knew that it might have to accept returns of all of the computer chips sold to those customers because it could not determine which chip sets contained defective chips. The Second Circuit concluded that it did not matter that Ikanos did not recall and agree to replace the defective chips at its expense until three months after the close of the offering and did not determine the extremely high failure rate of 25 percent to 30 percent until after the offering.[98]

Since *Panther*, other courts have agreed that a failure to provide disclosure about known trends or uncertainties in accordance with Item 303 of Regulation S-K could provide a basis for a violation of Section 11 and Section 12 of the Securities Act as long as the plaintiff pleads sufficient facts alleging that the defendant knew about the trend or uncertainty and reasonably expected that it would have a material unfavorable impact on the company's financial condition or results of operations.[99] One court was satisfied that a trend could be found based on developments during a nine-week period, observing that ''context matters, and what may not constitute a trend in one industry may signal a trend in another.''[100] In denying a motion to dismiss based on a failure to disclose a trend or uncertainty, another court noted that, since materiality is a fact-specific consideration, a complaint cannot be dismissed based on the immateriality of the trend or uncertainty information unless that information is immaterial as a matter of law.[101]

IV. Implications for Public Companies

Fait, *Litwin*, *Panther* and the other cases discussed in this article suggest that companies should consider whether to enhance their internal control over financial reporting and disclosure controls and procedures to strengthen their reliance on *Fait* for accounting estimates, judgments and opinions and ensure their preparation of a fully compliant MD&A. In this regard, companies may want to consider requiring additional documentation of their application of critical accounting policies and evaluation of appropriate disclosures for the MD&A. Contemporaneous documentation prepared by management can show that key opinions actually were held by management at the time that the judgment call was made or the estimate was established. Such documentation should reflect management's belief in the process used to determine the estimate as well as its consideration of alternatives and finally its belief that the judgment made, opinion reached or estimate arrived at reflected its best judgment or what it believed to be the case.

Documentation of the analysis of different views within a company may also be appropriate. All of the persons involved in preparing a company's financial statements may not be in agreement given the complexity of transactions, the diversity of alternative methods to prepare estimates and other factors, such as different levels of experience and varying levels of access to information. This lack of uniformity may be reflected in email traffic. Documentation of the resolution of the different views of those involved in preparing the financial statements may convince a trier of fact that a judgment or opinion actually was ''held'' by the principal decisionmaker[s]. Documentation of the company's analysis of known trends and uncertainties using the SEC's two-part test may protect the company from allegations that it should have disclosed a known trend or uncertainty.[102] Such documentation may also support an argument that the *Fait* protection for opinions should apply to its opinion that disclosure of a trend or uncertainty was not required.

Additional focus on the disclosure controls and procedures related to the analysis of trends and uncertainties in the preparation of the MD&A may also be appropriate. Despite SEC and SEC Staff suggestions since 2001 that companies should discuss in the MD&A known trends and uncertainties, including those critical accounting policies or estimates that affect their financial statements, because ''transparent disclosure is the most effective way to mitigate the potential for negative surprises and to advance the interests of investors,''[103] MD&As often do not provide meaningful information for an investor to understand how a company's financial statements could be affected if the trend, uncertainty, estimate, judgment or opinion was different. Plaintiffs may cite *Litwin*, *Panther* and their progeny as well as the SEC Staff's view that companies should discuss in the M&DA the judgments they made in making critical accounting estimates and the likelihood of materially different results if different judgments had been made or different conditions had existed.[104]

The MD&A should include appropriate disclosure about the assumptions that management relied on in preparing the estimates, judgments and opinions that are critical to the financial statements, including known trends and uncertainties that management may have

[97] 681 F.3d at 121.

[98] *Id.* at 121-22.

[99] *See, e.g., Silverstrand Inv. v. AMAG Pharm., Inc.*, 707 F.3d 95, 103 (1st Cir. 2013) (''To plausibly plead such a failure to disclose claim, a complaint must allege (1) that a registrant knew about an uncertainty before an offering; (2) that the known uncertainty is 'reasonably likely to have material effects on the registrant's financial condition or results of operation'; and (3) that the offering documents failed to disclose the known uncertainty.'')

[100] *Schuh v. HCA Holdings, Inc.*, No. 3:11-01033, 2013 BL 139102, at *7 (M.D. Tenn. May 28, 2013).

[101] *Id., at *8* ('' 'a complaint may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance,' '' quoting *N.J. Carpenters Health Fund v. The Royal Bank of Scotland Grp.*, 709 F.3d 109, 126 (2d Cir. 2013)).

[102] Failure to show that the two-part test was not followed may not eliminate a defense, since the two-part test is not in Item 303.

[103] Harvey L. Pitt, Op-Ed, *How to Prevent Future Enrons*, Wall St. J., Dec. 11, 2001, at A18.

[104] Securities Act Rel. No. 8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (Dec. 17, 2001). This was the SEC's first release discussing critical accounting policies.

taken into account in determining those estimates, judgments and opinions. Disclosure of the trends and uncertainties that management is monitoring because of their potential impact on the company's strategy, future results, and financial condition may also be warranted.

One way to identify trends and uncertainties that should be considered for discussion in the MD&A is for a company to review the risks and uncertainties discussed in the company's risk factors as well as any other trends and uncertainties that the company has been monitoring. To evaluate other critical accounting estimates, a company should consider carefully those accounting policies that require the use of judgments, assumptions, or factors that are subject to considerable uncertainty.

Enhancement of the MD&A may require a greater degree of coordination between the various persons who draft disclosures than exists in some companies today. Often it is the lawyers who draft risk factors and the accountants who draft the MD&A. The lawyers often do not know what estimates, judgments, assumptions or other factors would have had a material effect on the company's financial condition or operating performance if different decisions had been made with respect to those factors. The accountants who draft the MD&A may not be sufficiently aware of the developing jurisprudence or SEC approach to disclosures in the MD&A to understand how the MD&A can protect a company. To fully comply with Item 303, it would be helpful for a company's disclosure controls and procedures to require these parties to work together. Together they will be able to identify more effectively known trends and uncertainties and other factors that are reasonably expected to have a material effect on the company's financial condition or operating performance and to develop appropriate disclosure that enhances investors' ability to understand the predictive nature of the historical financial statements and protects the company from future liability.[105]

Conclusion

Fait and its progeny, aided by the accelerating trend under U.S. GAAP to require managements to make judgments, prepare estimates and include opinions in addition to statements of fact in the financial statements, promise substantial changes to the legal landscape for a wide range of accounting and disclosure cases that might be brought by both the SEC and private plaintiffs. However, the scope of *Fait* is limited both by the specifics of U.S. GAAP, and by the fact that estimates, judgments, and opinions can, on appropriate facts, be proved to have been both objectively false and disbelieved by management at the time they were made. There are ways in which plaintiffs can attack the defense that *Fait* provides, and ways in which management can enhance its ability to assert the application of *Fait*. Moreover, the SEC (and, in appropriate cases, private plaintiffs) can attack the processes by which registrants arrive at their financial statement numbers, and their MD&A disclosures. Registrants would be well advised to review internal control over financial reporting and their disclosure controls and procedures to anticipate and blunt those attacks.

[105] On August 13, 2013, the Public Company Accounting Oversight Board prepared new auditing standards that, if adopted, would require independent auditors to, among other things, conduct additional procedures in connection with their review of companies' annual reports filed under the Exchange Act, including the MD&A, and include in their report information about any material inconsistency, material misstatement of fact or both based on these procedures as well as the audit evidence obtained and conclusions reached during the audit. A similar proposal pertains to interim reports. PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditors' Report; and Related Amendments to PCAOB Standards*. If adopted, these requirements could affect the content and preparation of the MD&A.

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