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CLIENT ALERT

# Recent SEC Enforcement Action Highlights General Counsel's Responsibility for Disclosure of Litigation Contingencies

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The SEC recently filed an enforcement action in federal court accusing RPM International and its general counsel of securities law violations based on their failure to properly account for and disclose loss contingencies relating to a pending government investigation (*SEC v. RPM Int'l Inc*., 16-cv-1803 (D.D.C.)). This action highlights the responsibility of a public company's general counsel for disclosure of litigation and other material loss contingencies.

Under FASB Accounting Standards Codification Topic 450 ("ASC 450"), a public company facing a material loss contingency, such as a lawsuit or a government investigation, may be required to make certain disclosures regarding the contingency. The nature of the required disclosure varies depending on whether the likelihood of incurring the loss is "remote" (the chance of the future event is slight), "probable" (the future event is likely to occur), or "reasonably possible" (the likelihood falls in the range between being remote and probable). A loss contingency may involve asserted or even unasserted claims.

If a material loss contingency is reasonably possible and reasonably estimable, the company must disclose the nature of the loss contingency and provide its estimate of the amount or range of loss. If the company cannot estimate the amount of the reasonably possible loss, then it must disclose the nature of the contingency and describe why it is unable to estimate the amount of the loss.

According to the SEC's September 9, 2016 complaint, RPM faced a material loss in connection with a DOJ investigation, but the Ohio-based company's general counsel sought to protect his—and the company's—financial interests by repeatedly electing not to disclose or record an accrual for the loss contingency.

According to the complaint, RPM and its general counsel, Edward W. Moore, learned in 2011 that the DOJ was investigating claims that RPM's subsidiary Tremco overcharged the Government by at least $11.9 million dollars on certain roofing contracts. Moore oversaw RPM's response to the investigation. The SEC alleges that from the time he learned of the investigation until the investigation was resolved by a $60.9 million settlement in 2013, Moore knew but failed to inform senior managers and company auditors: (1) that RPM sent DOJ several analyses estimating that Tremco overcharged the government by at least $11.9 million on the contracts under investigation; (2) that RPM agreed to submit a settlement offer by a specific date to resolve the DOJ investigation; and (3) that, prior to submitting the settlement offer, RPM's overcharge estimates increased substantially to at least $27-28 million.

Moore was allegedly sensitive to RPM's desire to avoid further extraordinary charges following a period in which it had paid two one-time charges totaling $56 million. As an example, the SEC alleged that at an October 2, 2012 Audit Committee meeting, the Committee communicated that "we're not going to be accepting of ongoing extraordinary charges or one-time charges." Two days later, at RPM's annual shareholder meeting, RPM's CEO promised shareholders that RPM would not "water torture them" with additional one-time "charges quarter after quarter."

Moore was also alleged to have had financial incentive to conceal the loss contingency. According to the complaint, Moore owned more than $1.8 million in RPM stock. And, in Moore's own words, disclosing the investigation in RPM's first quarter SEC filings could have caused "uncertainty" and "depress[ed] the value of the stock." Moore also allegedly received bonuses linked to company performance in the years of the investigation.

According to the SEC, once RPM and Moore were aware of the investigation, they were bound to comply with various disclosure and accrual provisions of the federal securities law. Regulation S-X, for example, requires financial statements included with SEC filings to comply with Generally Accepted Accounting Principles. As noted above, ASC 450 requires an issuer to disclose a loss contingency if a material loss is reasonably possible, and to record an accrual for a loss contingency if a material loss is probable and reasonably estimable.

The SEC claims that as a result of Moore's failure to disclose key facts regarding the DOJ investigation, from October 2012 through December 2013, RPM submitted multiple materially false and misleading filings to the SEC. By extension, RPM failed to inform investors that a material loss was reasonably possible. In so doing, RPM and Moore allegedly violated "antifraud, books and records, and misleading accountant or auditor provisions of the securities laws." The SEC seeks civil money penalties, disgorgement of ill-gotten gains, and permanent injunctions against RPM and Moore.

This action should serve to remind general counsel of public companies to engage with the company's legal and accounting advisors whenever the company is faced with a loss contingency in order to reach the proper assessment of whether, and to what extent, disclosure may be required. Disclosure may be required not only under ASC 450, but also under securities regulations, including Item 103 of Regulation S-K (requiring disclosure about pending legal proceedings) and Item 303 of Regulation S-K (requiring disclosure in Management's Discussion and Analysis of certain trends and uncertainties and matter affecting liquidity). This engagement should continue for so long as the loss contingency is pending, as the likelihood or estimability of the loss may change over time.

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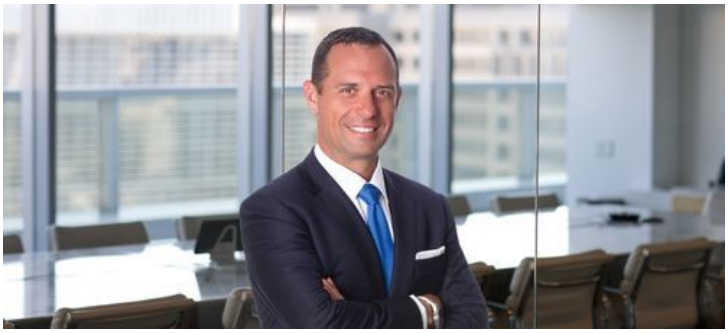

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