AU Section 9337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337

1. Specifying Relevant Date in an Audit Inquiry Letter

.01 *Question*—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, the date by which the lawyer's response should be sent to the auditor. Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

.02 *Interpretation*—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

.03 Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

[Issue Date: March 1977.]

2. Relationship Between Date of Lawyer's Response and Auditor's Report

.04 *Question*—The illustrative form of audit inquiry letter included in the appendix [section 337A] to section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, requests a response as to matters that existed at the balance sheet date and during the period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report, which is generally the date of the completion of field work?

.05 *Interpretation*—Section 560 paragraphs .10–.12 indicate that the auditor is concerned with events, which may require adjustments to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

[Issue Date: March 1977; Revised: December 2005.]

3. Form of Audit Inquiry Letter When Client Represents That No Unasserted Claims and Assessments Exist

.06 *Question*—The illustrative audit inquiry letter included in the appendix [section 337A] to section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, assumes that the client specifies certain unasserted claims and assessments. However, in some cases, clients have stated that there are no such claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome. What appropriate revision to the wording of the letter can be used in such situations?

.07 *Interpretation*—Wording that could be used in an audit inquiry letter, instead of the heading and first paragraph in the section relating to unasserted claims and assessments included in the appendix [section 337A] to section 337, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, is as follows:

> *Unasserted claims and assessments*—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

[Issue Date: March 1977; Revised: June 2009.]

4. Documents Subject to Lawyer-Client Privilege

.08 *Question*—Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .05*c*, states: "Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." Would this include a review of documents at the client's location considered by the lawyer and the client to be subject to the lawyer-client privilege?

.09 *Interpretation*—No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (see section 337 paragraph .13), section 337 paragraph .05(c) is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the client's counsel that the information is subject to that privilege and that the information was considered by the lawyer in responding to the audit inquiry letter or, if the matters are being handled by another lawyer, an identification of such lawyer for the purpose of sending him an audit inquiry letter.

[Issue Date: March 1977.]

5. Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer

.10 *Question*—The appendix [section 337A] of section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides an illustrative audit inquiry letter to legal counsel. That inquiry letter is based on the assumptions that (1) management of the company has prepared and furnished to the auditor and has set forth in the audit inquiry letter a description and evaluation of pending or threatened litigation, claims, and assessments and (2) management has identified and specified for comment in the audit inquiry letter unasserted claims or assessments that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. In many engagements, circumstances may render certain portions of the illustrative letter inappropriate. For instance, many clients ask their lawyers to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments rather than have management furnish such information. How can the wording of the inquiry letter be modified to recognize circumstances that differ from those assumed in the illustrative letter and to be more specific regarding the timing of the lawyer's response?

.11 *Interpretation*—Section 337 paragraph .09, outlines the matters that should be covered in a letter of audit inquiry. Although section 337 provides an illustrative audit inquiry letter to legal counsel, it should be modified, if necessary, to fit the circumstances. The modified illustrative audit inquiry letter that follows is based on a typical situation: management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments, and also represents that there are no unasserted claims or assessments that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. It also includes a separate response section with language that clarifies the auditor's expectations regarding the timing of the lawyer's response.

> "In connection with an audit of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation." [When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

.12 Pending or Threatened Litigation, Claims, and Assessments

"Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."

.13 Unasserted Claims and Assessments

"We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450.[1] We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB ASC 450. Please specifically confirm to our auditors that our understanding is correct."

.14 Response

"Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response."

"Please specifically identify the nature of and reasons for any limitations on your response."

"Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date)."[2]

[Issue Date: June 1983; Revised: June 2009.]

6. Client Has Not Consulted a Lawyer

.15 *Question*—Section 337 paragraph .06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, or assessments. In some instances, management may not have consulted a lawyer. In such circumstances, what should the auditor do to obtain sufficient, appropriate audit evidence regarding litigation, claims, and assessments?

.16 *Interpretation*—Section 337 is expressly limited to inquiry of lawyers with whom management has consulted. If the client has not consulted a lawyer, the auditor normally would rely on the review of internally available information as outlined in section 337 paragraph .05 and .07, and the written

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[1] A parenthetical statement such as "(excerpts of which can be found in the ABA's *Auditor's Letter Handbook*)" might be added here if the auditor believes that it would be helpful to the lawyer's understanding of the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. The *Auditor's Letter Handbook* contains, among other things, a copy of section 337, the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (section 337C), and excerpts from FASB ASC 450. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[2] Two auditing interpretations (see Interpretation Nos. 1–2 of section 337 [par. .01–.05]) address relevant dates in an audit inquiry letter and the relationship between the date of the lawyer's response and the audit report date.

representation of management regarding litigation, claims, and assessments as required by section 333, *Management Representations*, paragraph .06*o* and *p*. In those circumstances, the representation regarding litigation, claims, and assessments might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

.17 If information comes to the auditor's attention that may indicate potentially material litigation, claims, and assessments, the auditor should discuss with the client its possible need to consult legal counsel so that the client may evaluate its responsibility under Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies* to accrue or disclose loss contingencies. Depending on the severity of the matter, refusal by the client to consult legal counsel in those circumstances may result in a scope limitation, and the auditor should consider the effect of such a limitation on his audit report.

[Issue Date: June 1983; Revised: January 2004; Revised: March 2006; Revised: June 2009.]

7. Assessment of a Lawyer's Evaluation of the Outcome of Litigation

.18 *Question*—Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .09*d*(2), states that a letter of audit inquiry should include a request for the lawyer's evaluation of the likelihood of an unfavorable outcome of pending or threatened litigation, claims, and assessments to which he has devoted substantive attention. However, written responses from lawyers vary considerably and may contain evaluation wording that is vague or ambiguous and, thus, of limited use to the auditor. What constitutes a clear response and what should the auditor do if he considers the response unclear?

.19 *Interpretation*—The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (ABA Statement) is reprinted as exhibit II [section 337C] to section 337. While paragraph 5 of the ABA statement [section 337C] states that the lawyer "may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote'," he is not required to use those terms in communicating his evaluation to the auditor. The auditor may find other wording sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*.[3]

.20 Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is "remote" even though they do not use that term are:

- "We are of the opinion that this action will not result in any liability to the company."

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[3] Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, uses the terms *probable*, *reasonably possible*, and *remote* to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability, and the accounting standards for accrual and disclosure are based on those terms. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

.21 Absent any contradictory information obtained by the auditor either in other parts of the lawyer's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing.

.22 Because of inherent uncertainties described in section 337 paragraph .14 and in the ABA Policy Statement [section 337C], an evaluation furnished by the lawyer may indicate significant uncertainties or stipulations as to whether the client will prevail. The following are examples of lawyers' evaluations that are unclear as to the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term "meritorious defenses" indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate counsel's opinion that the company will prevail.)
- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If client's counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote," it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance," a "reasonable opportunity," and similar terms indicate more uncertainty than an opinion that the company will prevail.)

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in section 508 paragraphs .45–.49 to determine the effect, if any, of the lawyer's response on the auditor's report.

[Issue Date: June 1983; Revised: February 1997; Revised: June 2009.]

8. Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments

.24 Question—Section 337 paragraph .06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, and assessments. Sometimes, the client's inside general counsel or legal department (hereinafter referred to as "inside counsel") is handling litigation, claims, and assessments either exclusive of or in conjunction with outside lawyers. In such circumstances, when does inside counsel's response constitute sufficient, appropriate audit evidence regarding litigation, claims, and assessments?

.25 *Interpretation*—Section 337 paragraph .08 states that "Audit evidence obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration." Inside counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the client's legal needs, including litigation with outside parties. Because both inside counsel and outside lawyers are bound by the ABA's Code of Professional Responsibilities, there is no difference in their professional obligations and responsibilities. In some circumstances, outside lawyers, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, inside counsel has the primary responsibility for corporate legal matters and is in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information furnished by management.

.26 Audit inquiry letters should be sent to those lawyers, which may be either inside counsel or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims, and assessments. If inside counsel in handling litigation, claims, and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside counsel and outside lawyers have been involved in the matters, but inside counsel ha s assumed the primary responsibility for the matters, inside counsel's evaluation may well be considered adequate.[4] However, there may be circumstances when litigation, claims, or assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

.27 If both inside counsel and outside lawyers have devoted substantive attention to a legal matter, but their evaluations of the possible outcome differ, the auditor should discuss the differences with the parties involved. Failure to reach agreement between the lawyers may require the auditor to consider appropriate modification of his audit report.

[Issue Date: June 1983; Revised: March 2006.]

9. Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege

.28 *Question*—In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some clients

[4] This does not alter the caveat in section 337 paragraph .08 that "evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish."

have included the following or substantially similar language in the audit inquiry letter to legal counsel:

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

For the same reason, some lawyers have included the following or substantially similar language in their response letters to auditors:

> The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

Does the explanatory language about the attorney-client privilege or the attorney work-product privilege result in a limitation on the scope of the audit?

.29 *Answer*—No. According to the *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses*, explanatory language similar to the foregoing in the letters of the client or the lawyer is not a limitation on the scope of the lawyer's response. The report states that such language simply makes explicit what has always been implicit, namely, the language states clearly that neither the client nor the lawyer intended a waiver. The report further states that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges. The *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses* is reprinted in paragraph .30.

.30 Report of the Subcommittee on Audit Inquiry Responses[*]

Because of a recent court case and other judicial decisions involving lawyers' responses to auditors' requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

> Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

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[*] "Excerpted from 'Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,' *The Business Lawyer*, vol. 31, no. 3, April 1976, copyright 1976 American Bar Association, reprinted by permission of the American Bar Association."

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political, and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and to act in accordance with counsel's advice.

Paragraph (1) of the ABA Statement of Policy provides as follows:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5,[†] promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have suggested that clients include language in the following or substantially similar form:

[†] In July 2009, the Financial Accounting Standards Board (FASB) issued FASB *Accounting Standards Codification*™ (ASC) as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission. As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5, *Accounting for Contingencies*, has been codified as FASB ASC 450, *Contingencies*.

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

If client's request letter does not contain language similar to that in the preceding paragraph, the lawyer's statement that the client has so advised him or her may be based upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other communications or in discussions.

For the same reason, the response letter from some lawyers also includes language in the following or substantially similar form:

> The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

We believe that language similar to the foregoing in letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation of SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to lawyer's response as contemplated by subparagraph 1(*d*) of the Statement of Policy.

December 1989

[Issue Date: February, 1990.]

10. Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters

.31 *Question*—In order to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments, some lawyers include the following or substantially similar language in their responses to audit inquiry letters:

> "Please be advised that pursuant to clauses (*b*) and (*c*) of Paragraph 5 of the ABA Statement of Policy [American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*] and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the Company. We can only furnish information concerning those unasserted possible claims or assessments upon which the Company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the Company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same."

Does the inclusion of this or similar language result in a limitation on the scope of the audit?

.32 *Interpretation*—No. Additional language similar to the foregoing in a letter of a lawyer is not a limitation on the scope of the audit. However, the ABA Statement of Policy [section 337C] and the understanding between the legal and accounting professions assumes that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted possible claims or assessments.[5] Confirmation of this understanding should be included in the lawyer's response.

[Issue Date: January 1997; Revised: June 2009.]

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[5] See paragraph 6 of the ABA Statement of Policy [section 337C] and its commentary [section 337C]. In addition, Annex A to the ABA Statement of Policy [section 337C] contains the following illustrative language in the lawyers' response letter to the auditors:

> Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5, *Accounting for Contingencies*.

[See footnote †.] [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

AU Section 337C

Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Note: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer's response to letters of audit inquiry.

Source: SAS No. 12.

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5,* promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

a. Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

* In July 2009, the Financial Accounting Standards Board (FASB) issued FASB *Accounting Standards Codification*™ (ASC) as authoritative. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission. As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. FASB Statement No. 5, *Accounting for Contingencies*, has been codified as FASB ASC 450, *Contingencies*.

b. In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

c. Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

d. In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.*[†]

(3) *Response may be Limited to Material Items*. In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses*. Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies*. When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

a. *overtly threatened or pending litigation*, whether or not specified by the client;

[†] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

b. *a contractually assumed obligation* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

c. *an unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (*a*), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (*c*), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (*a*) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (*b*) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—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.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (*b*) and (*c*) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements[‡] of FAS 5.

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‡ Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

(7) *Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.*[†] *Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.*[†]

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

[†] See footnote † in paragraph (2) in this section.

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants *access* to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and third party contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

> "A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 [*] ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:[||]

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

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[*] See footnote * in paragraph (1) in this section.

[||] Citations are to paragraph numbers of FAS 5.

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) *If there is no accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (*c*) above are not met, *disclosure* may be required as provided in the following:

> "If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, *disclosure* of the contingency *shall be made when there is at least a reasonable possibility* that a loss or an additional loss may have been incurred. *The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of* a loss contingency involving *an unasserted claim* or assessment *when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable*." (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of audit evidence in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is notable to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

> "If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(*a*) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as

to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(*a*) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(*a*) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an unasserted possible claim may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

> "*probable*"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.
>
> "*remote*"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative form of letter for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter date [*insert date of request*] Mr. [*insert name and title of officer signing request*] of [*insert name of client*] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [*Federal income tax matters*] [*litigation*] [*real estate transactions*] [*describe other specific matters, as appropriate*] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*][**] loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]

Very truly yours,

[**] ***Note:*** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

Illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel[#] of [*insert name of client*] [(the "Company")] [(together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

I call your attention to the fact that as General Counsel[#] for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.*] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material][**] loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted

[#] It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

[**] See footnote ** earlier in this section.

possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5.* [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

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* See footnote * in paragraph (1) in this section.

AU Section 9337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337

1. Specifying Relevant Date in an Audit Inquiry Letter

.01 *Question*—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, the date by which the lawyer's response should be sent to the auditor. Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

.02 *Interpretation*—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

.03 Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

[Issue Date: March 1977.]

2. Relationship Between Date of Lawyer's Response and Auditor's Report

.04 *Question*—The illustrative form of audit inquiry letter included in the appendix [section 337A] to section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, requests a response as to matters that existed at the balance sheet date and during the period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report, which is generally the date of the completion of field work?

.05 *Interpretation*—Section 560 paragraphs .10–.12 indicate that the auditor is concerned with events, which may require adjustments to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the

CAQ SEC Regulations Committee
June 24, 2010 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

HIGHLIGHTS

NOTICE: The Center for Audit Quality (CAQ) SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging financial reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization. The highlights do not represent official positions of the CAQ. As with all other documents issued by the CAQ, these highlights are not authoritative and users are urged to refer directly to applicable authoritative pronouncements for the text of the technical literature. These highlights do not purport to be applicable or sufficient to the circumstances of any work performed by practitioners. They are not intended to be a substitute for professional judgment applied by practitioners.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

As available on this website, Highlights of Joint Meetings of the SEC Regulations Committee and its International Practices Task Force (IPTF) and the SEC staff are not updated for the subsequent issuance of technical pronouncements or positions taken by the SEC staff, nor are they deleted when they are superseded by the issuance of subsequent highlights or authoritative accounting or auditing literature. As a result, the information, commentary or guidance contained herein may not be current or accurate and the CAQ is under no obligation to update such information. Readers are therefore urged to refer to current authoritative or source material.

I. ATTENDANCE

A. SEC Regulations Committee

Chris Holmes, Chair
Melanie Dolan, Vice Chair
Peter Bible
Jack Ciesielski
Brad Davidson
Christine Davine
Tom Elder

Dave Follett
Bridgette Hodges
Jeff Lenz
Steve Meisel
Scott Pohlman
Amy Ripepi
Tom Weirich

B. Securities and Exchange Commission

Division of Corporation Finance

Wayne Carnall, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Mark Kronforst, Deputy Chief Accountant
Jill Davis, Associate Chief Accountant
Louise Dorsey, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Steven Jacobs, Associate Chief Accountant
Joel Levine, Associate Chief Accountant
Michael Stehlik, Assistant Chief Accountant
John Robinson, Academic Fellow
Mark Green, Senior Special Counsel
Nasreen Mohammed, Assistant Chief Accountant

C. Center for Audit Quality

Annette Schumacher Barr

D. Guests

Carolyn Clemmings, E&Y
John May, PwC

II. DIVISION OF CORPORATION FINANCE PERSONNEL UPDATE

Wayne Carnall announced that Michael Stehlik is now an Assistant Chief Accountant and announced that Mark Kronforst was awarded the Andrew Barr Award. Mr. Carnall also noted Joel Levine, previously the Assistant Director in the Office of Interactive Disclosure, has returned to the Division of Corporation Finance (the Division) as an Associate Chief Accountant.

III. CURRENT FINANCIAL REPORTING MATTERS

A. Effect of Current Events on Disclosures

Mr. Carnall commented that material implications of both the recent environmental issues in the Gulf of Mexico and the healthcare legislation should be discussed in MD&A. For example, if a gulf coast hotel chain is reasonably likely to have materially reduced revenue because it is reasonably likely there will be decreased tourism, or if an energy company is reasonably likely to experience material changes in results of operations because it is reasonably likely there will be an offshore drilling moratorium, those entities should evaluate the need to disclose that information in their MD&A.

B. REIT IPOs

Mr. Carnall summarized recent activity in real estate investment trust (REIT) initial public offerings (IPOs). In a number of transactions, the Division questioned whether the formation transaction required new basis accounting. Mr. Carnall noted that in the REIT structures that were being used, the SEC staff did not object to the presentation of carry-over basis financial statements.

C. Cheap Stock

Mr. Carnall addressed equity securities issued as compensation while a company was privately held in an IPO. Mr. Carnall encouraged companies to have contemporaneous valuations to determine the fair value of equity securities issued as, or underlying, compensation. The 2004 AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued As Compensation* (the Practice Aid) includes recommended disclosures. Mr. Carnall noted that the Practice Aid differentiates the extent of disclosures based on the nature of the valuation (independent contemporaneous valuation vs. retrospective or internal valuation). The SEC staff is currently evaluating an approach that places more focus on the inputs used in the valuations and expects to incorporate disclosure expectations into a future release of the Division's Financial Reporting Manual.

D. Contingency Disclosures

Mr. Carnall noted that in connection with its reviews, the staff has issued comments in situations in which the company does not appear to have complied with ASC 450, *Contingencies* (formerly SFAS No. 5). Mr. Carnall commented that when there was a reasonable possibility of a loss in excess of the amount accrued that these companies did not disclose an estimate of the amount of possible loss or range of loss or state that such an estimate cannot be made. Mr. Carnall added that he would expect that disclosures about a loss contingency would be updated as additional information becomes available. With the passage of time, there is a greater presumption that it would be possible for the company to provide quantitative information.

Mr. Carnall emphasized that the SEC staff expects registrants to comply with ASC 450, including the applicable disclosure requirements. In response to a question, Mr. Carnall indicated that the disclosure can be aggregated in a logical manner vs. separate disclosure for each asserted claim. Mr. Carnall noted that the staff has also recently issued comments when there was a large settlement with little or no disclosure in earlier periods – e.g., why wasn't there disclosure?

E. Domestic Companies with Majority of Operations Outside US

Mr. Carnall observed that a number of US domestic registrants have substantially all of their operations outside the US (e.g., in China). In certain situations, the SEC staff may ask questions regarding management's experience and capability of preparing financial statements in accordance with US GAAP. The objective of the questions is to evaluate management's assertion that it has effective internal control over financial reporting.

Additionally, Mr. Carnall discussed situations and shared observations in which these companies were audited by a registered independent public accounting firm domiciled in the US.

[See also PCAOB Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using The Work Of Other Auditors And Engaging Assistants From Outside The Firm*, which was issued on July 12, 2010.]

IV. IMPLEMENTATION AND INTERPRETATION OF RECENT SEC RELEASES

A. Section 404(b) for Non-Accelerated Filers

Under SEC rules, non-accelerated filers are required to comply with the auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act of 2002 with respect to reports on internal control over financial reporting in annual reports for fiscal years ending on or after 15 June 2010. The financial regulatory reform bill in House-Senate Conference includes a permanent exemption from Section 404(b) for non-accelerated filers. If the bill becomes law with the permanent exemption, Mr. Carnall expects the SEC would act quickly to modify existing SEC rules to make them consistent with the law.

In the absence of a change in rules, Mr. Carnall confirmed that a voluntary filer would be required to have an audit of its internal control over financial reporting after the current SEC deferral ends.

NOTE: The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010.

B. XBRL

The Committee noted that the detail XBRL tagging required in the second year of XBRL compliance is expected to be especially time consuming with respect to the guarantor condensed consolidating financial information footnote required by S-X Rule 3-10. The Committee questioned whether the SEC staff had considered allowing block tagging that footnote. Mark Green commented that the SEC's final rule, *Interactive Data to Improve Financial Reporting* (Release Nos. 33-9002, 34-59324) requires detail tagging of footnotes in the second year of a phase-in group's XBRL compliance. Mr. Green also stated that the condensed consolidating footnote is permitted by S-X Rule 3-10 as an exception to full financial statements of guarantors. Under that relief, a registrant has the benefit of only detail tagging the guarantor footnote as opposed to full guarantor financial statements. Joel Levine stated that the majority of the XBRL tags of elements in the guarantor footnote are consistent with the XBRL tags used in the primary financial statements.

Regarding XBRL transition, Mr. Green noted that a transcript of the XBRL Public Education Seminar, which discussed transition, is now available on the SEC website (see http://www.sec.gov./news/otherwebcasts/2010/xbrlseminar032310-transcript.pdf). Mr. Green commented there are no new XBRL transition interpretations to communicate.

V. SEC STAFF AND OTHER INITIATIVES

A. Financial Reporting Manual (FRM)

Mr. Carnall noted that he expects the FRM update as of March 31, 2010 to be issued soon. The update will include revisions to Section 2805 on general partner financial statements and the incorporation of selected topics included in Highlights of previous Joint Meetings of the Regs Committee and the SEC staff (Highlights). Additional selected topics from previous Highlights will be included in future FRM updates. Jill Davis reported on the project to compile 25 years of Highlights to allow the Division staff to incorporate current and relevant information into the FRM and Compliance and Disclosure Interpretations. *[Note: On July 7, 2010 an updated version of the FRM as of March 31, 2010 was posted to the SEC website.]*

B. CDIs on Disclosures of Non-GAAP Financial Measures

Mr. Carnall addressed the Division's Compliance and Disclosure Interpretations (CDIs) on the use of non-GAAP financial measures. He reiterated that the SEC staff generally would not require an SEC filing to include a non-GAAP financial measure. However, the company does have an obligation to ensure the information in the filing is not misleading. For example, the disclosure of non-

GAAP information outside of the filing should not contradict the information included in the filing.

Mr. Kronforst noted that registrants have received SEC staff comments about inconsistencies within their SEC filings or inconsistencies between the SEC filing and information outside of the SEC filing. Such comments are not limited to non-GAAP financial measures.

Mr. Carnall noted the Division staff has not performed an analysis to determine whether more non-GAAP financial measures are being included in SEC filings subsequent to the CDIs release, but acknowledged many registrants with December year-ends may not have had the opportunity to fully reassess their disclosures with respect to non-GAAP financial measures based upon the January 2010 release date of the CDIs.

C. CDIs on Regulation S-K

Regulation S-K CDI 119.24 notes that an equity incentive plan award with a service period preceding the grant date, resulting from the compensation committee’s ability to exercise discretion to reduce the award, should be reported in the Summary Compensation Table (SCT) and Grants of Plan-Based Awards Table (GPAT) as compensation in the year in which the service inception date begins. Notwithstanding the accounting treatment for the award, the SEC staff believes reporting the award in this manner better reflects the compensation committee’s decision to establish the award arrangement. The amount reported in both tables should be the fair value of the award at the service inception date, based upon the then-probable outcome of the performance conditions. The award should also be included in total compensation for the purposes of determining whether the executive officer is a named officer.

Mr. Carnall commented that the staff understands that situations in which the service inception date precedes the grant date are not common and when it does exist is frequently limited to the top executives. In these situations, preparers and auditors should evaluate the terms to determine the appropriate accounting.

Steven Jacobs noted the treatment specified by the CDI could apply to other situations based upon specific facts and circumstances. He added that the basis for the treatment specified by the CDI was to report compensation in the period of the compensation committee’s decision to authorize and establish the award arrangement. However, the CDI would not apply to an equity award grant that requires shareholder or some additional level of approval, which should be reported in the SCT and the GPAT in the period that approval has been obtained.

D. Core Disclosure Project

Mr. Carnall noted that the pending financial regulatory reform legislation, and the resulting requirements for extensive SEC rulemaking, may delay the Division's planned core disclosure project.

VI. CURRENT PRACTICE ISSUES

A. Summarized financial information of equity investees

The table below sets forth the source of equity method investee disclosure guidance, the number of significance tests, the disclosure threshold and the determination of significance for interim and annual reporting by smaller reporting companies and other reporting companies.

	Other Reporting Companies		Smaller Reporting Companies	
	Annual	**Interim**	**Annual**	**Interim**
Source	Rule 4-08(g)	Rule 10-01(b)(1)	Rule 8-03(b)(3)[1]	Rule 8-03(b)(3)
Disclosure threshold	Exceeds 10%	Exceeds 20%	Exceeds 20%	Exceeds 20%
Number of tests	3	2	3	3
Asset test	The registrant's and its other subsidiaries' proportionate share of the total assets of the equity method investee as a percentage of the total assets of the registrants and its subsidiaries consolidated as of the end of each fiscal year presented.	N/A	Same as other reporting companies, except the asset test also applies to interim reporting.[2]	
Investment (equity) test	The registrant's and its other subsidiaries' investments in and advances to the equity method investee as a percentage of the total assets of the registrant and its subsidiaries consolidated as of the end of each fiscal year presented.	For interim measurement, use both the most recent balance sheet, which should correspond to the end of the year-to-date (cumulative) interim period used to measure significance under the income test, and the balance sheet as of the end of the most recently completed fiscal year that is included in the quarterly report.[3]	Same as other reporting companies.[2]	
Income test	The registrant's and its other subsidiaries' equity in the income from continuing operations <u>before income taxes</u>, extraordinary items and cumulative effect of a change in accounting principle of the equity method investee exclusive of amounts attributable to any noncontrolling interests as a percentage of such income of the registrant and its subsidiaries consolidated for each fiscal year presented.	For interim measurement, use the year-to-date interim period income statements.	The registrant's and other subsidiaries' equity in the income from continuing operations attributable to the equity method investee as a percentage of such income of the registrant and its subsidiaries consolidated for each fiscal year presented. For interim measurement, use the year-to-date interim period income statements. (This computation uses an <u>after-tax measure of income</u>.)	

In determining whether summarized financial information is required in either annual or interim financial statements, Mr. Carnall commented that a smaller reporting company may elect to apply the significance tests applicable to smaller reporting companies or other reporting entities and select the least onerous significance calculation for each significance test.

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1 The SEC Division of Corporation Finance Financial Reporting Manual (FRM) Notes to Section 2420.9 state, "The smaller reporting company requirement for summarized financial information is located within the S-X 8-03 requirements for interim financial statements. Notwithstanding the location of this requirement, the staff applies the S-X 8-03 requirement for summarized financial information to both annual and interim financial statements."

2 The FRM Notes to Section 2420.9 state, "The staff did not intend for the disclosure requirements for a smaller reporting company to be more onerous than those for a registrant that is not a smaller reporting company. Therefore, the staff determines significance for purposes of reporting summarized financial information by smaller reporting companies in a manner consistent with S-X 1-02(w), substituting 20% for 10%."

3 Interim investment test guidance is from Section 2420.7 of the FRM.

B. PCAOB Registration for Auditors of Equity Method Investees

Mr. Carnall indicated that the chart in FRM 4110.5 would be revised to clarify the requirements of when the auditor of an equity affiliate needs to be registered with the PCAOB. Specifically, if the "substantial role" test is not met, the auditor of the equity affiliate does not need to be registered.

Mr. Carnall also noted that a Form 8-K filing by a special purpose acquisition company (SPAC) to report the acquisition of a predecessor entity (or by a public company to report an acquisition accounted for as a reverse merger) is deemed equivalent to an IPO registration statement that requires both a PCAOB registered firm and PCAOB standards with respect to the acquired company.

C. Impact on Article 11 Pro Forma Income Statement of Changes in the Fair Value of Contingent Consideration Related to a Business Combination (Update to Attachment #5 from April 2010 Meeting)

S-X Rule 11-02(b)(6) requires that pro forma adjustments related to a pro forma condensed income statement be computed assuming the transaction was consummated at the beginning of the fiscal year presented and include adjustments that give effect to events that are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the company, and (iii) factually supportable.

ASC 805 (formerly SFAS No. 141(R)) requires that contingent consideration issued in a business combination be recorded at its fair value on the acquisition date, and classified as either an asset, as a liability or as equity. Subsequent changes in fair value for asset- and liability-classified contingent consideration are usually recognized in earnings until the arrangement is settled.

The Committee questioned how a pro forma income statement that is being updated in connection with a new or amended registration statement or proxy/information statement should reflect known changes in the fair value of contingent consideration in post-acquisition periods. Mr. Carnall noted that the SEC staff does not believe such statements should reflect any pro forma adjustments to give effect to changes in the fair value of contingent consideration in periods different than those in which such changes were recognized in the acquirer's post-acquisition income statements. The SEC staff expects the pro forma financial information to include transparent disclosure about the contingent consideration arrangement and known changes in its fair value.

D. Pro Forma Income Information for a Business Combination – Computation and Presentation in MD&A

When a public company has completed a business combination, the accounting literature (ASC 805) requires disclosure of pro forma information in the notes to the financial statements. If comparable financial statements are presented, the

GAAP pro forma information reflects two alternative (and mutually exclusive) scenarios: prior year earnings as if the transaction occurred at the beginning of the prior year and current year earnings as if the transaction occurred at the beginning of the current year.

Under Regulation S-X Rule 11-02(c)(2)(i), when there has been a significant business combination, the registrant should present a pro forma condensed statement of income for the most recent fiscal year and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required. In effect, the Article 11 pro forma reflects just one scenario: prior year and year to date earnings as if the transaction occurred at the beginning of the prior year.

Item 303 of Regulation S-K (MD&A) requires the registrant to analyze the three-year period covered by the financial statements using year-to-year comparisons based on the financial statements included in the filing. The SEC staff has acknowledged that "there may be situations where comparisons other than those of the historical financial information may provide valuable supplemental and in certain cases, more relevant analyses, to fully discuss trends and changes." When a registrant determines that a supplemental discussion in MD&A based on pro forma information is appropriate and will enhance the discussion, FRM 9220.7 states that the pro forma financial information generally should be presented in a format consistent with S-X Article 11 but acknowledges that other formats may be appropriate depending on the facts and circumstances.

The Committee questioned whether a registrant may utilize GAAP pro forma information as the basis for a supplemental discussion in MD&A. Mr. Carnall stated that if Article 11 pro formas are included in a filing, it makes the most sense to use the Article 11 pro formas as the basis for any MD&A supplemental disclosures. If the filing includes both Article 11 and GAAP pro formas, the filing should explain the differences in the two pro forma presentations. If the GAAP pro formas are used as a basis for any MD&A supplemental disclosures, MD&A should include clear disclosure of the basis of the pro forma comparison. The SEC staff noted that in some cases, the registrant may choose to limit its supplemental discussion to the effect of the business combination on revenues; in these circumstances, the adjustments to arrive at the pro forma amount of revenue may be limited and easy to explain. In other cases the registrant may believe it is appropriate to also discuss the effect of the business combination on earnings. In these circumstances, the registrant may need to provide more detail regarding the nature and amount of the adjustments so that investors understand how the pro forma earnings amount was computed.

CAQ SEC Regulations Committee
September 21, 2010 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

HIGHLIGHTS

NOTICE: The Center for Audit Quality (CAQ) SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging financial reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA and do not represent an official position the AICPA or the CAQ. As with all other documents issued by the CAQ, these highlights are not authoritative and users are urged to refer directly to applicable authoritative pronouncements for the text of the technical literature. These highlights do not purport to be applicable or sufficient to the circumstances of any work performed by practitioners. They are not intended to be a substitute for professional judgment applied by practitioners.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

As available on this website, Highlights of Joint Meetings of the SEC Regulations Committee and its International Practices Task Force (IPTF) and the SEC staff are not updated for the subsequent issuance of technical pronouncements or positions taken by the SEC staff, nor are they deleted when they are superseded by the issuance of subsequent highlights or authoritative accounting or auditing literature. As a result, the information, commentary or guidance contained herein may not be current or accurate and the CAQ is under no obligation to update such information. Readers are therefore urged to refer to current authoritative or source material.

I. ATTENDANCE

A. SEC Regulations Committee

Chris Holmes, Chair
Melanie Dolan, Vice Chair
Peter Bible
Jack Ciesielski
Brad Davidson
Christine Davine
Tom Elder
Len Gatti

Bridgette Hodges
Jeff Lenz
Steve Meisel
Scott Pohlman
Amy Ripepi
Tom Weirich
Don Zakrowski

B. Securities and Exchange Commission

Division of Corporation Finance

Wayne Carnall, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Mark Kronforst, Deputy Chief Accountant
Angela Crane, Associate Chief Accountant
Jill Davis, Associate Chief Accountant
Louise Dorsey, Associate Chief Accountant
Michael Fay, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Stephanie Hunsaker, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
Michael Stehlik, Assistant Chief Accountant
Angela Andrews, Academic Fellow
Mark Green, Senior Special Counsel
Nasreen Mohammed, Assistant Chief Accountant

C. Office of Interactive Data

Jeff Naumann, Assistant Director

D. Center for Audit Quality

Annette Schumacher Barr

E. Guests

Carolyn Clemmings, E&Y
John May, PwC

II. DIVISION OF CORPORATION FINANCE PERSONNEL AND ORGANIZATIONAL UPDATE

A. Personnel Changes

Wayne Carnall announced the following personnel changes in Division:

- Paula Dubberly was named the Division's new Deputy Director of Policy and Capital Markets. Ms. Dubberly will oversee two new offices in the Division, one focused on asset-backed securities and other structured finance products, the second focused on new securities products and capital market trends.
- Angela Andrews is the Division's new Academic Fellow. During her fellowship, Ms. Andrews will assist in analyzing and evaluating data for IFRS-related projects, among other activities. Ms. Andrews obtained her PhD from Michigan State and is an assistant professor at Wayne State University.
- Joel Levine, formerly the Assistant Director, Office of Interactive Disclosure, has returned to the Division as an Associate Chief Accountant. Mr. Levine will be working on IFRS-related projects in the near term.
- Michael Fay, Associate Chief Accountant, has been assigned to the Division's Regulatory Policy group working with Deputy Chief Accountant Mark Kronforst.
- Brian Breheny, the Deputy Director for Legal and Regulatory Policy, has left the Division. His position has not yet been filled.

B. New Division Offices

On July 16, 2010, the Division announced the creation of three specialized offices to enhance its disclosure review and policy operations. The new offices will focus on (1) large financial services companies, (2) asset-backed securities and other structured products and (3) new securities products and capital markets trends. Mr. Carnall described the office (and twelfth industry group) that will focus on large financial services companies – including the largest banks, but excluding the insurance companies. As it will be concentrating on the largest financial services companies, the number of companies that will be assigned to this group will be significantly less than the other 11 AD groups. The smaller number of registrants will allow the SEC staff in the new office to perform more "continuous reviews" – the review of all filings shortly after the filing is made. In addition, Mr. Carnall explained that this office plans to explore new approaches to performing filing reviews. One such method might be to engage in an ongoing dialogue with its registrants. As an example, Mr. Carnall observed that the SEC staff might meet periodically with certain registrants to discuss staff comments on the filing.

Mr. Carnall noted that the large financial services companies office may not be fully operational until 2011 because key staff positions will need to be filled and various operational aspects will need to be addressed.

III. CURRENT FINANCIAL REPORTING MATTERS

A. Implications of the Dodd-Frank Act

Mr. Carnall shared the following observations regarding financial reporting implications of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act):

- **Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX)**

  The SEC's final rule, *Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, exempts non-accelerated filers from Section 404(b) of the Sarbanes-Oxley Act of 2002. Mr. Carnall noted that non-accelerated filers are not required to comply with Section 404(b) of SOX by statute.

  Members of the Committee noted that they had received inquiries concerning the scope of the exemption - specifically, whether any issuer with public float below $75 million would be exempt from 404(b) of SOX. The staff noted that the Commission's rules are specific to issuers that are neither accelerated filers nor large accelerated filers as those terms are defined in Exchange Act Rule 12b-2. Further, the accelerated filer exit provisions specify that an accelerated filer does not become a non-accelerated filer unless its worldwide public float decreases below $50 million at the annual measurement date. The Committee suggested the SEC staff re-emphasize the interplay of the accelerated filer exit provisions and Section 404(b) compliance, perhaps in a Compliance & Disclosure Interpretation (CDI).

- **Dodd-Frank Act Section 1504, *Disclosure of Payments by Resource Extraction Issuers***

  This provision of the Act requires the SEC to issue rules requiring SEC registrants to disclose payments made to foreign governments and the US Federal Government in their annual reports. The Dodd-Frank Act requires the SEC to issue a final rule no later than 270 days from July 21, 2010 (the date of enactment). The SEC has indicated that it intends to propose related disclosure rules in the fourth quarter of 2010 and adopt final rules in the first quarter of 2011. Accordingly, it is unlikely that the new rules would be effective in time for the 2010 Form 10-K filings of calendar year registrants.

- **Dodd-Frank Act Section 1503, *Reporting Requirements Regarding Coal or Other Mine Safety***

  This provision of the Act requires SEC registrants that operate mines directly or through a subsidiary to disclose certain mine safety information in their periodic filings. The Act does not require the SEC to issue new rules to implement the provisions of this Section, although the SEC is authorized to do so. The SEC currently plans to propose rules regarding disclosure of mine safety information in November to December 2010 timeframe. Section 1503 took effect on August 20, 2010 and registrants will be required to comply in their periodic reports filed after this date.

Note: *[The SEC website contains a detailed timeline for the Commission's implementation of the Dodd -Frank Act. See http://sec.gov/spotlight/dodd-frank.shtml.]*

B. Loss Contingency Disclosures

Mr. Carnall noted that the SEC staff continues to focus on loss contingency disclosures and whether companies are in compliance with the existing requirements of GAAP for contingent losses (ASC 450, *Contingencies* (formerly SFAS No. 5)). In particular, Mr. Carnall noted that the staff is seeking to determine registrants' compliance with the existing GAAP requirement to disclose, if significant, the amount or range of reasonably possible losses in excess of the amount accrued. Additionally, upon the announcement of a material settlement, the SEC staff may review prior period disclosures and make inquiries of registrants to understand (1) whether appropriate disclosure was made if the contingent loss was reasonably possible as of previous reporting dates, and (2) whether any related accruals were appropriately recognized (and disclosed in MD&A if necessary) in the period the contingent loss became probable and reasonably estimable. Additionally, the staff may inquire about periods in which the company recognizes the expense.

Mr. Carnall also commented that the loss contingency disclosure requirements of GAAP and Item 103, *Legal Proceedings*, of Regulation S-K have different objectives. Mr. Carnall observed that attempts to satisfy both objectives through an integrated set of disclosure often result in lengthy factual recitations rather than focusing on the underlying loss contingency, the related exposure and the likelihood of a loss.

C. Non-GAAP Financial Measures

Mr. Carnall summarized recent SEC staff comments on non-GAAP financial measures, including:

- It is inappropriate to present a full non-GAAP income statement in an SEC filing. (Question 102.1 of the CDIs on Non-GAAP Financial Measures states that such presentation attaches undue prominence to the non-GAAP information.)
- The prohibition on presenting non-GAAP financial measures with greater prominence than GAAP measures encompasses both the order of presentation and the degree of emphasis. For example, the SEC staff may challenge a discussion of non-GAAP financial measures that significantly exceeds the length of the discussion of the corresponding GAAP measures.
- The presentation of a non-GAAP financial measure should clearly describe the nature of any adjustments to a standard measure and should not describe an adjusted measure using terminology that would imply it is an unadjusted measure. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled "EBITDA". (See Question 103.01 of the CDIs on Non-GAAP Financial Measures)
- If a registrant has a GAAP net loss but discloses non-GAAP net income, any presentation of non-GAAP earnings per share should be based on, or accompanied by a presentation of, non-GAAP diluted earnings per share that gives effect to any dilutive potential common shares outstanding even if they were antidilutive to the computation of diluted GAAP loss per share.

Mr. Carnall also commented that the SEC staff may listen to earnings and analysts calls to learn about a company and may issue comments on a discussion of inappropriate financial measures. For example, the SEC staff may challenge the oral discussion or website disclosure of operating cash flow per share or other per share measures not in accordance with ASR 142, which states that per share data other than that relating to net income, net assets and dividends, should be avoided in reporting financial results.

D. Article 11 Pro Forma Financial Information for an Acquired Foreign Business

When a US domestic issuer acquires a foreign business, the acquired business' financial statements presented to comply with Rule 3-05 of Regulation S-X (Rule S-X 8-04 for smaller reporting companies) may be prepared on a comprehensive basis other than U.S. GAAP (e.g., IFRS or local GAAP). Mr. Carnall commented that registrants are not required to separately present the conversion of the acquired foreign business's balance sheet and income statement to US GAAP in the pro forma adjustments. The SEC staff will not object if the adjustments to conform to US GAAP and the purchase accounting adjustments are combined for purposes of presentation in the pro forma information.

Mr. Carnall also noted that all the columns in the pro forma information should be presented using the reporting currency of the SEC registrant. Accordingly, the balance sheet and income statement of an acquired foreign business usually should be converted to the reporting currency to allow the pro forma columns to sum. The pro forma presentation should disclose the basis for the conversion either in narrative form or in a supplemental schedule to the pro forma information.

E. Venezuela

Considering the continued deterioration of economic conditions, Mr. Carnall emphasized the need for disclosure by any company with potential material exposure to further devaluations of the Venezuelan currency. Mr. Carnall had commented on the recommended disclosures in the April 2010 Committee meeting. Highlights of the April 2010 meeting are available at: http://thecaq.org/resources/secregs/pdfs/highlights/2010_0406_Highlights.pdf.

IV. IFRS WORK PLAN

Mr. Carnall noted that the Division staff is spending substantial time on the IFRS Work Plan. This work includes a review/analysis of financial statements of some of the largest companies in the world that use IFRS – both registrants and non registrants. One of the objectives of this project is to evaluate whether significant jurisdictional or other differences in the application of IFRS exist. The SEC staff will issue a progress report on the Work Plan in October 2010. Mr. Carnall indicated that this financial statement review project will not be completed until 2011.

V. XBRL

SEC XBRL rules required large accelerated filers with worldwide public float greater than $5 billion to detail tag financial statement notes and schedules for periods ending on or after June 15, 2010. Members of the Committee conveyed observations about the difficulties and delays many of these registrants encountered in their first detail XBRL tagging. Members of the Committee again expressed concern about the potential adverse effects of the XBRL timing requirements on the quality of financial reporting because of the incremental time required to reflect changes to the draft financial statements in the XBRL data. Specifically, members of the Committee noted that there could be as much as a 24-48 hour turnaround period to update the XBRL information for changes to the draft financial statements. As a result, registrants may decline to revise financial statements in response to comments from the audit committee and independent auditors.

Mark Green commented that the rules anticipated a learning curve in XBRL implementation. Mr. Green noted that the SEC rules addressed potential XBRL filing issues by (1) requiring the largest companies to implement XBRL reporting first as part of a three-year phase-in, (2) providing a 30 day grace period for a registrant's first block tagged and detail tagged XBRL flings and (3) permitting registrants to request a hardship exemption. Mr. Green noted the SEC staff will continue to monitor the XBRL filing process. Jeff Naumann noted that the SEC staff also plans to communicate overall XBRL filing observations from its reviews. Although some comments may be communicated to individual registrants, the majority of XBRL comments will be made through a summary report on observations from all XBRL filing reviews.

Members of the Committee encouraged the SEC staff to closely monitor the resolution of the recent XBRL challenges in succeeding period reports and consider whether any adjustments to the SEC's XBRL reporting deadlines and requirements are warranted.

Mr. Green also highlighted that the Division issued updated Interactive Data CDIs on September 17, 2010 to clarify transition to XBRL reporting. The CDIs are consistent with April and June 2010 XBRL discussions with the Committee. The Interactive Data CDIs are available at: http://www.sec.gov./divisions/corpfin/cfguidance.shtml#interactivedata.

Wayne Carnall added that foreign private issuers that use US GAAP and have a float in excess of $5 billion that block tagged in their December 31, 2009 20-F would be required to detail tag interim information for periods after June 15, 2010 that are provided to comply with Form 20-F Item 8.A.5 nine month updating requirement. While the adopting release could be read to imply that a company would have one year to do block tagging, the regulation text is clear that for periods after June 15, 2010 detailed tagging is required.

VI. SEC STAFF AND OTHER INITIATIVES

A. Financial Reporting Manual (FRM)

The next update to the Division's Financial Reporting Manual (FRM) is expected to be issued soon, with updates dated as of June 30, 2010. Another FRM update, with updates dated September 30, 2010, is planned for later in the fall. By the FRM update in March 2011 (with updates dated December 31, 2010), the Division expects to complete the incorporation of selected past Committee Highlights.

[Note: On October 1, the SEC staff issued its quarterly update of the FRM. The revisions include updates for issues related to Regulation S-X Rule 3-09, Rule 3-10, and Rule 3-16, as well as other changes. The revisions are reflected as of June 30, 2010 and therefore do not reflect items attributable to the Dodd-Frank Act.]

B. CDIs Regarding Consents from Securities Ratings Agencies

Section 939G of the Dodd-Frank Act repealed Securities Act Rule 436(g), which previously exempted nationally registered statistical ratings organizations (NRSRO) from being considered experts when their securities ratings were used in a registration statement under the Securities Act. The Division issued Securities Act Rules CDIs 233.04 to 233.08 in response to the Dodd-Frank Act to clarify when a NSRSO is required to provide its consent. CDI 233.04 states the NRSRO's consent would be required if the issuer includes the credit rating in its registration statement or Section 10(a) prospectus (directly or through incorporation by reference), unless the rating information is included only for the purpose of satisfying disclosure requirements ("issuer disclosure-related ratings information"). The CDI cites the following as examples of issuer disclosure-related ratings information: disclosure of a credit rating in the context of a risk factor discussion, changes to a credit rating, MD&A discussion of the liquidity of the registrant, the cost of funds for a registrant, or the terms of agreements, including potential support to variable interest entities, that refer to credit ratings. Members of the Committee noted that issuers frequently have questions regarding whether or not a particular disclosure would trigger a consent requirement and about progress toward a solution for asset-backed issuers at the expiration of the 6 month transition period provided by the SEC staff in July 2010. Mr. Carnall thanked the Committee for sharing their concerns. Given the nature of the issue, he recommends that companies discuss the issue with their legal counsel and if necessary, questions can be directed to the Office of Chief Counsel.

VII. CURRENT PRACTICE ISSUES

A. Financial Statements of "Lower Tier" Companies

The SEC staff has previously addressed whether financial statements of "lower tier" entities (i.e., acquirees and equity investees) are required with respect to entities for which financial statements are required under S-X Rules 3-05, 3-09, 3-10 and 3-16 (and any corresponding rules applicable to smaller reporting companies). Topic 2, *Other Financial Statements Required*, of the FRM provides much of the interpretive guidance.

The SEC staff has not provided similar interpretive guidance with respect to acquired real estate operations for which financial information is required under S-X Rule 3-14. If a registrant acquires real estate operations whose financial statements include either recently acquired properties or investments in real estate that are accounted for under the equity method, the Committee questioned whether S-X Rule 3-14 requires any financial information with respect to such "lower tier" real estate operations. Mr. Olinger commented that such fact patterns do not arise often and the appropriate financial presentation should be determined based on the specific facts and circumstances. Accordingly, the Division staff encourages pre-filing consultation by registrants in these circumstances.

B. Applicability of the Disclosure Requirements of Item 3(f) of Form S-4 When the Target is a Reporting Company That is Significant at or below the 20% Level

Item 3(f) of Form S-4 sets forth certain pro forma and pro forma equivalent per share disclosures that may be required in connection with a business combination transaction. Item 17(b)(7)(ii) of Form S-4 indicates that pro forma and comparative share data are not required for an insignificant nonreporting target if the registrant's shareholders are not voting and the transaction is not a roll-up. The Committee asked whether a registrant is required to provide the disclosures set forth in Item 3(f) of Form S-4 if all of the elements specified by Item 17(b)(7)(ii) are present except that the insignificant target is an SEC reporting company. Mr. Olinger responded that registrants should follow the specific Form S-4 instructions if an insignificant target is an SEC reporting company (i.e., provide the disclosures set forth in Item 3(f) of Form S-4), but may wish to discuss their circumstances with the SEC staff if compliance with the instructions of Form S-4 is problematic.

423 F.3d 899
United States Court of Appeals,
Eighth Circuit.

In re: ACCEPTANCE INSURANCE COMPANIES SECURITIES LITIGATION
Lawrence I. Batt, P.C. Profit Sharing Plan and Trust, Individually and on Behalf of All Others Similarly Situated, Plaintiff,
Jerome S. Richman, Co–Trustee of the Joe Sonken Trust; Diana L. Kinder; Barbara Winer Revocable Trust, on Behalf of Themselves and a Class of All Others Similarly Situated, Plaintiffs—Appellants,
v.
Acceptance Insurance Companies, Inc.; Kenneth C. Coon; Georgia M. Mace; AICI Capital Trust; John P. Nelson, Defendants—Appellees,
William J. Gerber; Jay A. Bielfield; Edward W. Elliot, Jr.; Robert Lebuhn; Michael R. McCarthy; R.L. Richards; David L. Treadwell; Doug T. Valassis; Advest, Inc.; Everen Securities; Deloitte & Touche, LLP, Defendants.

No. 04–2078.
|
Submitted: Feb. 14, 2005.
|
Filed: Aug. 29, 2005.

Synopsis
Background: Investors brought securities fraud action against insurer and three of its corporate officers. The United States District Court for the District of Nebraska, Laurie Smith Camp and Thomas M. Shanahan, JJ., granted defendants' motions to dismiss and for summary judgment, 352 F.Supp.2d 940, and investors appealed.

Holdings: The Court of Appeals, Melloy, Circuit Judge, held that:

investors allegations were insufficient to state claim against the insurer's officers for making a material misstatement or omission in a registration statement, and

experts' affidavits, which took shareholders' statements as true and did not review the record to see if the statements were supported, could not be considered on motion for summary judgment with regard to securities fraud claim.

Affirmed.

Attorneys and Law Firms

***901** Robert A. Wallner, argued, New York, New York (Shannon L. Hopkins, Marvin L. Frank, and Gregory B. Linkh, on the brief), for appellant.

Leah J. Domitrovic, argued, Chicago, Illinios (David H. Kistenbroker, Matthew J. Cannon, Joni S. Jacobsen, Michael S. Weisman, and Katten Muchin Zavis Rosenman, on the brief), for appellee.

Before MELLOY, HEANEY, and FAGG, Circuit Judges.

Opinion

MELLOY, Circuit Judge.

This is an appeal of a shareholder liability suit against Acceptance Insurance Companies and some of its officers. The shareholder group appeals the district court's [1] orders granting a motion to dismiss and a motion for summary judgment as to all of their claims.

The Appellants raise three major issues in this appeal. First, they argue that the district court erred by granting the Appellees' motion to dismiss their claims under Sections 11 and 15 of the Securities Act. Second, the Appellants argue that the district court erred by denying their motion to amend their complaint as to Section 11 claims. Third, the Appellants argue that the district court should not have granted the motion for summary judgment on the Exchange Act Section 10(b) and SEC Rule 10b–5 claims. We affirm.

I.

The shareholders of Acceptance Insurance Companies, Inc. ("Acceptance"), a Delaware corporation, directly sued Acceptance, AICI Capital Trust ("AICI"), and the officers of Acceptance: Kenneth Coon, Georgia Mace, and John Nelson. AICI was and is a wholly-owned subsidiary of Acceptance. The primary allegation of the shareholders was that Acceptance failed to have adequate reserves in place prior to ***902** 1999 to account for increased claims stemming from a California Supreme Court decision.

Reserves, as reported by an insurance company, are estimates of its liabilities and expenses that it will pay on claims already reported and claims that may exist, but have not yet been reported. In the area of unreported claims, an insurer must engage in some speculation and, as a result, could over- or under-estimate appropriate reserves. A company is said to have inadequate reserves if it does not allocate sufficient funds to offset a likely loss contingency scenario.

The officers of Acceptance reported the company's reserves quarterly with assistance from external accountants. In this case, PricewaterhouseCoopers ("PWC") reviewed the reserve estimates, and, after discussion with Acceptance, a final figure was reported in each quarter in Acceptance's public filings. Because the reserve figures were estimates of future contingencies, Acceptance and PWC offered a range of figures. From 1996 to 1999, PWC found that Acceptance's reserve figures met the requirements of Nebraska insurance law and were computed using generally accepted accounting principles ("GAAP"). During the relevant time period, Acceptance's and PWC's independent estimates were within five percent of each other, and Acceptance's numbers were both above and below PWC's figures.

In 1995, the California Supreme Court, in *Montrose Chem. Corp. of Cal. v. Admiral Ins. Co.,* 10 Cal.4th 645, 42 Cal.Rptr.2d 324, 913 P.2d 878 (1995), issued an opinion that was significant for construction insurance claims. The decision applied a continuous injury trigger of coverage, broadening liability relative to previous law. *Id.* at 889–90. After the decision, Acceptance crafted explicit exclusions into its policies to avoid *Montrose*-related claims. However, for the policies written before 1995, an increase in the number of claims was anticipated due to the decision in *Montrose.*

In 1997, Nebraska amended its annual statement requirements to require greater detail for loss contingencies that could affect reserves. As a result, Acceptance added cautionary language alluding to the *Montrose* decision and its effect on reserves. Such language did not exist for the previous public filings made by Acceptance. In 1999, Acceptance made the decision to increase its reserve estimates due to increased claims for incidents prior to 1995 in California related to *Montrose.* Prior to Acceptance's decision, three other insurance companies had already begun reporting *Montrose*-specific reserves in their public filings.

In 2001, in another action against Acceptance, *Magid v. Acceptance Ins. Co.,* 2001 WL 1497177, *8 (Del.Ch.2001), the Delaware Court of Chancery stated that the effect of *Montrose* was significant and the company may have needed to make timely adjustments to its reserves. The issue in *Magid* was more limited than the present matter, and the *Magid* court did not render any specific findings that Acceptance was under-reserved during the class period.

The district court granted a defense motion to dismiss one claim and a defense motion for summary judgment as to all others. The shareholders have appealed.

II.

On appeal, the Appellants argue that the district court erred by dismissing the shareholders' suit under Section 11 of the Securities Act of 1933 on the grounds that the complaint contained no factual allegations to support the claims described therein. The Securities Act is primarily designed to ensure that investors receive ***903** information concerning the issuance of securities. The Act prohibits misrepresentations and fraud in the sale of securities. Since the district court granted dismissal based upon a motion to dismiss under Federal Rules of Civil Procedure 12(b)(6), we review the issue de novo. *Romine v. Acxiom Corp.,* 296 F.3d 701, 704 (8th Cir.2002).

There is liability under Section 11 if "any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). To establish a Section 11 claim, a plaintiff must show that he or she bought the security and that there was a material misstatement or omission. *Herman & MacLean v. Huddleston,* 459 U.S. 375, 382, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). There is no scienter requirement for a Section 11 claim. *In re NationsMart Corp. Sec. Litig.,* 130 F.3d 309, 315 (8th Cir.1997).

Further, the particularity requirements of Federal Rule of Civil Procedure 9(b) do not apply to Section 11 claims. *Id.* at 314.

A related issue that the parties and the district court addressed with the Section 11 claim was whether Acceptance followed proper accounting principles. Under 17 C.F.R. § 210.4–01(a)(1), financial statements to the SEC must be made in accordance with GAAP. The Appellants allege that Acceptance did not adhere to Financial Accounting Standard No. 5 (FAS–5) in accounting for its contingencies. To comply with FAS–5, a loss contingency statement must include information available prior to the issuance of the financial statement explaining that an asset had been impaired or the amount of loss in the future can be reasonably estimated. The Appellants' claim under Section 11 is that the Appellees' registration statement misstated the reserve holdings of the company because they did not take into account the *Montrose* decision. A registration statement is a set of documents, including a prospectus, that a company disseminates in conjunction with an issuance of securities.

The district court held that the Appellants' Section 11 claim was insufficient as a matter of law. Even under the liberal pleading requirements of Federal Rule of Civil Procedure 8(a), the district court found that the Appellants had failed to state any facts to support their claim. Notably missing was any fact alleged in the complaint that indicated Acceptance's reserves were inadequate in light of the *Montrose* decision.

Appellants argue that numerous statements made by the Appellees after the registration statement was issued show that Acceptance's reserves were inadequate at the time of issuance. However, this type of retrospective analysis of awareness cannot be the basis for a claim. *See, e.g., Scibelli v. Roth,* 2000 WL 122193, *3 (S.D.N.Y.2000) (noting that it is “not a reasonable inference” to assume prior knowledge based upon actual knowledge at a later date). Under both FAS–5 and Section 11, information is required to be included only if it is available prior to the issuance of a financial statement. The Appellants' complaint alleges no such facts to support prior knowledge by the Appellees. The Appellants are only able to cite comments after the statement was issued. Even those alleged facts close in time to the issuance of the statement only speak to the general importance of the *Montrose* decision, not the failure to assess any loss contingency.

While the Appellees did not mention the *Montrose* decision specifically in their filings, they did include more general cautionary ***904** language about the risk of judicial findings on specialty-type insurance programs. They mentioned that court holdings could have an adverse effect on reserves and subsequent losses could occur as a result. The Appellants allege no facts to suggest that this general language was inadequate to provide warning of *Montrose*-related claims. Further, Appellants do not cite any legal authority to support the contention that specific mention of the *Montrose* decision was required by law.

As a result, we conclude that there is no error with the district court's finding that plaintiffs asserted no facts, other than mere conclusions, to show that Acceptance was under-reserved during the class period.

III.

After discovery, the Appellants sought leave to amend their Section 11 claim. The district court denied the Appellants' motion to amend because the Appellants had unduly delayed seeking amendment, the Appellants acted in bad faith during discovery, and the amendment would be futile. Generally, we review denial of leave to amend for abuse of discretion. *Wheeler v. Missouri Highway & Transp. Comm'n,* 348 F.3d 744, 753 (8th Cir.2003). However, for the narrow issue of futility, we review de novo. *In re K–Tel Int'l, Inc. Sec. Litig.,* 300 F.3d 881, 899–900 (8th Cir.2002).

In making its argument that the district court erred regarding the denial of leave to amend, the Appellants largely repeat the same arguments they made in support of their Section 11 claim. Given that there are no substantive differences in the facts offered in the proposed amendment, we conclude that the amendment would be futile.

In the alternative, we find no error in the findings of delay and bad faith. Findings of bad faith and undue delay can support a denial of leave to amend. *United States ex rel. Gaudineer & Comito, L.L.P. v. Iowa,* 269 F.3d 932, 936 (8th Cir.2001). Appellants offer no reason to find the district court was in error except to argue that the district court approved the relevant scheduling order. This, however, does not address the larger issue of bad faith, and we cannot find any argument to support the notion that the district court abused its discretion. As a result, we find no error by the district court in denying leave to amend.

IV.

The Appellants also argue that summary judgment was inappropriate because a reasonable jury could have found that the individual officer defendants knowingly or recklessly misled the shareholders in violation of Sections 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), and SEC Rule 10b–5, 17 C.F.R. § 240.10b–5.

Rule 10b–5 effectively tracks Section 10(b), so we discuss those claims in terms of Rule 10b–5. Our analysis applies to both claims. Rule 10b–5 makes it unlawful to "make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" concerning a publicly traded company. Although not specified in Rule 10b–5, scienter of intentional misbehavior or recklessness is required. *Florida St. Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 653 (8th Cir.2001).

Because the Appellants' 10(b) and 10b–5 claims rely on the same basic material misstatements as described for the Section 11 claim, all of the arguments in the previous ***905** section apply here as well. There are, however, other reasons why the district court granted summary judgment for the defendants on the 10(b) and 10b–5 claims.

The district court found that the Appellants were unable to meet the scienter requirements of the relevant sections. The Appellants correctly assert that, in general, state of mind issues are to be decided by the jury. However, issues of scienter can be resolved as part of a summary judgment for the defendant if there is no genuine issue of material fact. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 256, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Further, issues of scienter under 10(b) and 10b–5 are subject to the more stringent pleading requirements of the Private Securities Litigation Reform Act (PSLRA). Under the PSLRA, the plaintiff must, "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2).

The Appellants argue that the district court failed to view all facts in a light most favorable to them on the scienter issue. The most significant piece of evidence which the Appellants argue was undervalued by the district court was a statement recorded in notes by an employee, Wilkins, attributed to Mace that the "[p]ast problem was probably pressure for earnings. Sounded like we committed a sin in the past." The statement, however, was found to be inadmissible hearsay by the district court. Although the statement was a business record, the second level of hearsay, attributing the statement to Mace, did not fit into an exception.

The Appellants argue that the statement was an admission by a party opponent and/or falls under the general hearsay exception. However, the district court was well within its discretion in finding that the statement was not an admission to the facts in this case. The Appellants can only offer conjecture to connect the statement with the present case, and that is not sufficient for this court to override the judgment of the district court on this evidentiary issue.

The district court also found that the Appellants' expert affidavits were inadmissible on this issue. The standard of review for excluding expert testimony is abuse of discretion. *General Electric Co. v. Joiner,* 522 U.S. 136, 141, 118 S.Ct. 512, 139 L.Ed.2d 508 (1997). Applying *Daubert v. Merrell Dow Pharm., Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993), the district court screened the expert testimony for relevance and reliability. The district court found that the testimony was unreliable because it was not supported by any methodology and not particularly helpful to the court. Ultimately, the district court felt the opinions were mere legal conclusions with no analytical reasoning or support.

The two experts took the shareholders' statements as true and did not review the record to see if the statements were supported. The opinions themselves were more or less legal conclusions about the facts of the case as presented to the experts by the shareholders. As a result, the expert opinions were merely opinions meant to substitute the judgment of the district court. *S. Pine Helicopters, Inc. v. Phoenix Aviation Managers, Inc.,* 320 F.3d 838, 841 (8th Cir.2003). When the expert opinions are little more than legal conclusions, a district court should not be held to have abused its discretion by excluding such statements. *United States v. Ingle,* 157 F.3d 1147, 1152 (8th Cir.1998).

The other statements offered by the Appellants to prove scienter do not show ***906** knowing falsity about the reserves. They do show concern about the *Montrose* decision, but they do not weigh on the issue of a failure to properly account for reserves. Without evidence of intentional falsity, the Appellants' claim cannot survive summary judgment.

For the above reasons, as well as those cited in Section II, the district court was within its discretion when it granted the motion for summary judgment on the Section 10(b) and Rule 10b–5 claims.

V.

For the reasons stated above, we affirm the judgment of the district court.

All Citations

423 F.3d 899, Fed. Sec. L. Rep. P 93,336

Footnotes

1 The Honorable Thomas M. Shanahan, United States District Judge for the District of Nebraska and The Honorable Laurie Camp Smith, United States District Judge for the District of Nebraska both granted motions for the issues on appeal in this case.

349 F.Supp.2d 685
United States District Court,
S.D. New York.

In re CIT GROUP, INC. SECURITIES LITIGATION
THIS ORDER RELATES TO: ALL ACTIONS

No. 03 Civ. 02471(JES).
|
Dec. 21, 2004.

Synopsis
Background: Investors brought securities fraud class actions against corporation and individual directors, alleging materially misleading statements in registration statement and prospectus. Following consolidation of actions, defendants moved to dismiss.

Holdings: The District Court, Sprizzo, J., held that:

prospectus statement that loan loss reserves relating to particular portfolio were believed adequate was not rendered materially misleading by consolidated nature of reserve;

same statement and second statement that reserves had been reviewed for adequacy were not rendered materially misleading by fact that reserves were not in fact adequate;

statements were not rendered materially misleading by reserves' augmentation shortly after initial public offering; and

statements were not material given cautionary language and relative insignificance of augmentation.

Motion granted.

Attorneys and Law Firms

***686** Milberg Weiss Bershad Hynes & Lerach LLP, New York, NY (Sanford P. Dumain, Benjamin Y. Kaufman, Jeffrey T. Spinazzola, of counsel), for Lead Plaintiffs.

Law Offices of Lawrence G. Soicher, New York, NY (Lawrence G. Soicher, of counsel), Cohen, Milstein, Hausfeld & Toll, PLLC, New York, NY (Catherine A. Torell, of counsel), Bernstein, Liebhard & Lifshitz, LLP, New York, NY (Sandy A. Liebhard, of counsel), Rabin Murray & Frank, New York, NY (Marvin L. Frank, of counsel), Weiss & Yourman, New York, NY (Joseph H. Weiss, of counsel,) for plaintiffs.

Fried, Frank, Harris, Shriver & Jacobson, New York, NY (Douglas H. Flaum, Brett D. Jaffe, of counsel), for Defendants CIT Group, Inc., Albert R. Gamper, Jr., and Joseph M. Leone.

Cleary, Gottlieb, Steen & Hamilton, New York, NY (Max Gitter, Jennifer L. Kroman, of counsel), for Defendants Goldman Sachs & Co., Lehman Brothers Inc., and Salomon Smith Barney Inc.

MEMORANDUM OPINION AND ORDER

SPRIZZO, District Judge.

Plaintiffs, members of the class of individuals who purchased CIT Group, Inc. ("CIT") common stock in or traceable to CIT's July 1, 2002 initial public offering ("IPO"), bring this action to recover for materially misleading statements made in ***687** CIT's registration statement and prospectus. Plaintiffs seek recovery pursuant to sections 11, 12(a)(2), and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77***o***. Defendants, CIT, Albert Gamper, Jr., and Joseph Leone ("defendants"), bring this motion to dismiss plaintiffs' complaint for failure to state a claim upon which relief can be granted pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. [1] For the reasons set forth below, the Court grants defendants' motion.

BACKGROUND

On July 1, 2002, CIT, a global finance company, launched an IPO that resulted in the issuance of 211.6 million shares and the generation of over $4.8 billion. Consolidated and Amended Class Action Complaint ("Compl.") ¶¶ 17, 20-21. In connection with that IPO, CIT prepared, and filed with the SEC, a registration statement and prospectus. *Id.* ¶ 18. Defendants Gamper, Jr., and Leone, who were among other things CIT's Chief Executive Officer and Chief Financial Officer, respectively, signed that registration statement. *Id.* ¶¶ 8-9.

Along with other information, the registration statement and incorporated prospectus identified risk factors that could negatively impact CIT and the value of its stock. *Id.* ¶ 26. One such factor was the risk of under-performance in the company's telecommunications portfolio. *Id.* To guard against such risks, CIT represented that, as of March 31, 2002, it maintained consolidated reserves for credit losses in the amount of $554.9 million. *Id.* ¶ 31. CIT declared that this reserve level had been "reviewed for adequacy." *Id.* With regard specifically to the risk in the telecommunications portfolio, the registration statement and prospectus stated, *"We believe that our loan loss reserves relating to the telecommunications portfolio are adequate.* However, *continued deterioration* in the sector could result in losses beyond current reserve levels." *Id.* ¶ 26 (alteration in original).

On July 23, 2002, three weeks after the IPO, CIT issued a press release that announced its results for the quarter ending June 30, 2002. *Id.* ¶ 22. In that release CIT indicated that it was taking an additional $200 million loan loss charge in order to strengthen its telecommunications loan loss reserves. [2] *Id.* Plaintiffs allege that, at the time of the IPO, defendants were aware that this step would need to be taken. *Id.* ¶ 28. CIT common stock closed at $17.53 per share on April 10, 2003, the date that the initial complaint was filed in this action. *Id.* ¶ 56. The IPO price was $23 per share. *Id.*

Six class action complaints were filed and, pursuant to a June 23, 2003 order, this Court consolidated these separate actions into this action and appointed Glickenhaus & Co. as lead plaintiff. Plaintiffs contend that the statements above regarding the telecommunications loan loss reserves and the consolidated loan loss reserves were untrue statements of material fact that are actionable under sections 11, ***688** 12(a)(2), and 15 of the Securities Act. [3] *Id.* ¶ 18.

DISCUSSION

In considering a motion to dismiss, a court must accept all of the allegations set forth in the complaint as true, and must draw all reasonable inferences in favor of the plaintiffs. *Rombach v. Chang,* 355 F.3d 164, 169 (2d Cir.2004); *Halperin v. eBanker USA.com, Inc.,* 295 F.3d 352, 356 (2d Cir.2002). Dismissal is appropriate only when it is clear that the plaintiffs can prove no set of facts "in support of their claims that would entitle them to relief." *Halperin,* 295 F.3d at 356. In addition to the complaint, the court may consider those documents that are incorporated into the complaint by reference. *Rombach,* 355 F.3d at 169;*Hinerfeld v. United Auto Group,* No. 97 Civ. 3533, 1998 WL 397852, at *4, 1998 U.S. Dist. LEXIS 10601, at *11 (S.D.N.Y. July 15, 1998).

Here, plaintiffs allege that statements concerning CIT's loan loss reserves made in the registration statement and prospectus violate sections 11, 12(a)(2), and 15 of the Securities Act.

Section 11 creates a cause of action for purchasers of securities against issuers, underwriters, signatories, and directors for registration statements that "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). As to issuers the provision "imposes a form of strict liability," such that plaintiffs need only show that the misstatements or omissions were material in order to state a claim. *Greenapple v. Detroit Edison Co.,* 618 F.2d 198, 203 & n. 9 (2d Cir.1980); *seealsoHerman & MacLean v. Huddleston,* 459 U.S. 375, 381-82, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). *But seeRombach,* 355 F.3d at 171 (stating that plaintiffs "need allege no more than negligence to proceed" under sections 11 and 12(a)(2)).

Section 12 creates liability as against those who "sell[ ] a security ... by means of a prospectus or oral communication" that contains material misstatements or omissions. 15 U.S.C. § 77*l* (a)(2). Section 15 simply imposes derivative liability against those who control section 11 or 12 violators. *Id.*§ 77***o***; *Hinerfeld,* 1998 WL 397852, at *4 n. 4, 1998 U.S. Dist. LEXIS 10601, at *12 n. 4.

Statements will be deemed materially misleading when " 'the defendants' representations, taken together and in context, would have misled a reasonable investor.' " *Rombach,* 355 F.3d at 172 n. 7 (quoting *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.,* 936 F.2d 759, 761 (2d Cir.1991)). Under this standard the prospectus must be read as a whole to determine if any misstatements "would have misled a reasonable investor about the nature of the [securities]," *Olkey v. Hyperion 1999 Term Trust, Inc.,* 98 F.3d 2, 5 (2d Cir.1996) (quoting *McMahan & Co. v.*

Wherehouse Entertainment, Inc., 900 F.2d 576, 579 (2d Cir.1990)), and individual statements should not be parsed to determine if each was "literally true," *id.*

Here, plaintiffs point to two statements in the registration statement and prospectus that they claim are materially misleading. ***689** Compl. ¶¶ 18, 32. Plaintiffs advance several theories as to the misleading nature of these statements. *Id.*

Plaintiffs first point to CIT's statement that "[w]e believe that our loan loss reserves relating to the telecommunications portfolio are adequate." Jaffe Decl., Ex. C, at 10, Prospectus ("Prospectus"). Plaintiffs contend that this is a material misstatement because CIT did not have loan loss reserves that were devoted solely and explicitly to the telecommunications portfolio. Compl. ¶ 32; Pls.' Mem. at 6.

This Court cannot agree. The statement, even read in complete isolation, does not state that CIT had reserves that were separately maintained as "telecommunications loan loss reserves." Rather, the clear import of the statement was that among the loan loss reserves that the company did have, an ample amount could be devoted to the telecommunications portfolio so as to offset any probable losses. In fact, on the same page as the allegedly misleading statement, CIT stated in its prospectus, "We maintain a *consolidated reserve for credit losses on finance receivables.* Our *consolidated reserve for credit losses* reflects management's judgment of losses inherent in the portfolio." Prospectus at 10 (emphasis added). Therefore, the allegedly misleading statement, taken together with the balance of the prospectus, would not have misled a reasonable investor. *See,e.g.,Lasker v. New York State Elec. & Gas Corp.,* 85 F.3d 55, 58-59 (2d Cir.1996).

Plaintiffs next point to the above statement about the adequacy of the telecommunications reserves along with those in which CIT stated that its consolidated loan loss reserves had been "reviewed for adequacy." Prospectus at 10-11, 32; Compl. ¶¶ 18-19, 32. Plaintiffs contend that these statements are actionable because CIT's loan loss reserves were not, in fact, adequate. Compl. ¶¶ 18, 32; Pls.' Mem. at 9-10. Plaintiffs argue that CIT's augmentation of its loan loss reserves three weeks subsequent to the IPO is evidence of their inadequacy. Pls.' Mem. at 2-3.

This Court disagrees. Although these misstatements may be actionable under the theory that defendants did not actually believe them to be true or had no reasonable basis for such a conclusion, *In re Int'l Bus. Machs. Corporate Sec. Litig.,* 163 F.3d 102, 107 (2d Cir.1998); *Hinerfeld,* 1998 WL 397852, at *7, n. 9, 1998 U.S. Dist. LEXIS 10601, at *22 n. 9, they would not be actionable under the securities laws if they simply represented a failure on the part of defendants to correctly gauge the adequacy of the loan loss reserves, *Hinerfeld,* 1998 WL 397852, at **6-7, 1998 U.S. Dist. LEXIS 10601, at *21-22 ("The failure to anticipate the extent of necessary reserves, even if it amounts to mismanagement, is not actionable under federal securities laws."); *see alsoOlkey,* 98 F.3d at 7-8 (stating that claim which amounted to an allegation that defendants were less skillful at balancing the portfolio than plaintiffs would have liked was not actionable under the securities laws); *Shapiro v. UJB Fin. Corp.,* 964 F.2d 272, 281 (3d Cir.1992) ("[M]ere failure to provide adequate reserves ... does not implicate the concerns of the federal securities laws and is not normally actionable."), unless they were worded so as to create guarantees on the part of defendants, *In re Int'l Bus. Machs.,* 163 F.3d at 107;*Friedman v. Mohasco Corp.,* 929 F.2d 77, 79 (2d Cir.1991); *Milman v. Box Hill Sys. Corp.,* 72 F.Supp.2d 220, 234 (S.D.N.Y.1999).

Here, plaintiffs' claim that loan loss reserves were inadequate is nothing more than an assertion that CIT was incorrect or unskillful in determining exactly what amount of reserves would be adequate. ***690** That this statement could be actionable is even further undercut by the context in which the statement was made. The prospectus stated:

> The consolidated reserve for credit losses is intended to provide for losses inherent in the portfolio, which requires the application of estimates and significant judgment....We cannot be certain that our consolidated reserve for credit losses will be adequate over time to cover credit losses in our portfolio.... [I]f our reserves for credit losses are not adequate, our business, financial condition and results of operations may suffer.

Prospectus at 11. Defendants clearly stated the risk associated with any unskillfulness on their part and they clearly indicated that they did not guarantee that loan loss reserves would be adequate over time. Therefore, this statement is not actionable under this theory. *SeeOlkey,* 98 F.3d at 7-8;*Milman,* 72 F.Supp.2d at 234.

Plaintiffs' final allegation is that these statements were materially misleading because defendants knew when they made these statements that they were not true. [4] Compl. ¶¶ 19, 28. As stated *supra,* statements about defendants' belief in the adequacy of loan loss reserves could be actionable if it is alleged that defendants did not actually believe that loan loss reserves were adequate, or if defendants had no reasonable factual basis for their belief. *SeeVirginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083, 1092-93, 111 S.Ct. 2749, 115 L.Ed.2d 929 (1991); *Shapiro,* 964 F.2d at 282;*Milman,* 72 F.Supp.2d at 234.

Here, plaintiffs argue that defendants could not have actually believed that loan loss reserves were adequate, Compl. ¶¶ 19, 23, because defendants decided to increase loan loss reserves just three weeks after the IPO, [5] Compl. ¶ 22; Pls.' Mem. at 23-24. Plaintiffs provide no additional facts from which to infer that defendants did not believe that reserves were adequate or had no reasonable basis for such a belief.

That defendants later decided to revise the amount of loan loss reserves that it deemed adequate provides absolutely no reasonable basis for concluding that defendants did not think reserves were adequate ***691** at the time the registration statement and prospectus became effective. [6] *SeeDenny v. Barber,* 576 F.2d 465, 470 (2d Cir.1978) (dismissing Rule 10b-5 claim in which plaintiff simply pointed to later disclosures as evidence of misstatements in the original disclosures); *Milman,* 72 F.Supp.2d at 234 (dismissing section 11 claim where no facts alleged that defendants did not believe prediction or had reason to doubt its truth); *Hinerfeld,* 1998 WL 397852, at *6, 1998 U.S. Dist. LEXIS 10601, at *21 (dismissing section 11 claim where allegations that defendants knew or should have known that reserves were inadequate were "conclusory and unsupported by additional factual allegations").

Plaintiffs also completely fail to plead any facts from which it could be inferred that defendants' belief in the adequacy of the reserves was beyond the pale of reason. In fact, the statements that plaintiffs rely on completely belie this inference. In the registration statement and prospectus defendants stated that they believed that loan loss reserves for telecommunications were adequate, but they also acknowledged a "substantial decline" in the industry and indicated an understanding that "continued deterioration in the sector could result in losses beyond current reserve levels." Prospectus at 10. Given the absence of any facts to show that defendants did not believe, or have a reasonable basis to believe, that the reserves were adequate, this Court cannot simply draw an inference based upon mere speculation that this was the case. *SeeIn re Time Warner Inc. Sec. Litig.,* 9 F.3d 259, 266 (2d Cir.1993) (finding statements of opinion not actionable where "the complaint contains no allegations to support the inference ... that the favorable opinions were without a basis in fact"); *Hinerfeld,* 1998 WL 397852, at *6, 1998 U.S. Dist. LEXIS 10601, at *21.

Besides finding that plaintiffs have failed to allege any misstatements in the registration statement and prospectus, this Court also dismisses this Complaint on the ground that the alleged misstatements, taken in the context of the registration statement and prospectus as a whole, were " 'so obviously unimportant ... that reasonable minds could not differ on the question of [their] importance.' " *I. Meyer Pincus & Assocs. v. Oppenheimer & Co., Inc.,* 936 F.2d 759, 763 (2d Cir.1991) (quoting *Goldman v. Belden,* 754 F.2d 1059, 1067 (2d Cir.1985)). This Court finds that, given the extensive cautionary language that surrounded the statements, Prospectus at 10, the explanation that the chosen level of reserves was the product of "estimates and significant judgment," Prospectus at 11, and the relative unimportance of an additional $240 million charge to loss reserves in a company with over $27 billion in receivables, Prospectus at 5, the statements would not have misled a reasonable investor about the nature of the securities offered. *Olkey,* 98 F.3d at 5;*In re Allied Capital Corp. Sec. Litig.,* No. 02 Civ. 3812, 2003 WL 1964184, at *5, 2003 U.S. Dist. LEXIS 6962, at *16-17 (S.D.N.Y. Apr. 25, 2003) (finding that no reasonable investor would have found misstatements in estimates that overvalued holdings in $237 million worth of assets material in a company that had $2.3 billion in assets).

Because the Court finds that none of the statements complained of were materially ***692** misleading, plaintiffs have failed to state actionable claims under sections 11 and 12(a)(2) of the Securities Act. It therefore follows that no cause of action has been stated under section 15.*See,e.g.,Hinerfeld,* 1998 WL 397852, at *8, 1998 U.S. Dist. LEXIS 10601, at *24.

Pursuant to this Court's obligation under 15 U.S.C. § 77z-1(c)(1), this Court finds that all parties and attorneys have complied with the requirements of Rule 11(b) of the Federal Rules of Civil Procedure.

CONCLUSION

Based on the foregoing, defendants' motion to dismiss plaintiffs' Complaint shall be and hereby is granted. The Court directs the Clerk of the Court to enter judgment dismissing the Complaint as against defendants CIT, Gamper, Jr., and Leone. A Pre-Trial Conference shall occur on January 31, 2005 at 3:00 p.m. in Courtroom 705, 40 Centre Street to determine the status of this action as against remaining defendants.

It is SO ORDERED.

All Citations

349 F.Supp.2d 685, Fed. Sec. L. Rep. P 93,058

Footnotes

1 One of the consolidated actions also names John F. Fort, III, Mark H. Swartz, J. Brad McGee, Goldman, Sachs & Co., Lehman Brothers Inc., and Salomon Smith Barney Inc. as defendants. Those defendants were not named in the Consolidated Amended Class Action Complaint and apparently were not served.

2 CIT also announced a $40 million charge to strengthen its Argentine loan loss reserves. Compl. ¶ 22. Given that plaintiffs' claims regarding misstatements about the Argentine portfolio are identical, but weaker, than those in connection with the telecommunications portfolio, this Court will primarily discuss the telecommunications issue.

3 Plaintiffs also argue that these misstatements resulted in an overstatement of assets and an understatement of risks in violation of Generally Accepted Accounting Principles. Compl. ¶ 18. As defendants point out, however, these alleged GAAP violations are completely dependent upon the underlying statements at issue here. Defs.' Mem. at 20. Since this Court finds no material misstatements, it therefore need not address further the alleged GAAP violations.

4 Defendants contend that the gravamen of this argument sounds in fraud and therefore the pleading requirements of Fed.R.Civ.P. 9(b) should apply. Defs.' Mem. at 12-13. The Second Circuit has recently held that, even though section 11 causes of action do not require proof of fraud, plaintiffs whose complaints sound in fraud will need to conform to the more stringent pleading requirements of Rule 9(b). *Rombach,* 355 F.3d at 167. The *Rombach* Court indicated that courts should analyze the conduct that was alleged to have taken place, rather than the words used by plaintiffs, in determining whether the claim sounds in fraud. *Id.* at 171. In this case, plaintiffs repeatedly state that their causes of action are not premised on fraud. Compl. ¶¶ 59, 67, 74. Although this Court thinks that an allegation that defendants reported that loan loss reserves were adequate despite “already kn[owing] at the time of filing ... that the Company did not have adequate reserves,” Compl. ¶ 28, unquestionably sounds in fraud and therefore implicates Rule 9(b), this Court relies on other bases for dismissal of this action.

5 Plaintiffs also make the unmeritorious argument that CIT's Form 10-K, filed on February 26, 2003, proves that defendants did not believe that reserves were adequate because that filing indicates, “In light of the continued deterioration in the telecommunications sector, [CIT] added $200 million to reserve for credit losses *during* the quarter ended 6/30/02.” Compl. ¶ 23 (alteration in original); Jaffe Decl., Ex. E, Form 10-K. According to plaintiffs, this “unmistakably shows that the Company decided to increase its telecommunications reserve *during* the quarter ending June 30, 2002 and prior to the IPO on July 1, 2002.” Compl. ¶ 23. Clearly the statement in the Form 10-K does not make such an assertion.

6 Such a finding is consistent with public policy. To infer that defendants did not actually believe these statements simply because they undertook subsequent remedial measures would do nothing but dissuade restatements and corrections of financial data. *Cf.*Fed.R.Evid. 407 (excluding evidence of subsequent remedial measures to prove negligence or other culpable conduct); *Greenapple,* 618 F.2d at 211 (“[T]he advisability of revision does not render what was done deceptive or misleading.”).

768 F.3d 1046
United States Court of Appeals,
Ninth Circuit.

In re NVIDIA CORPORATION SECURITIES LITIGATION,
Roberto Cohen; New Jersey Carpenters Pension and Annuity Funds, on behalf of themselves and all others similarly situated, Plaintiffs–Appellants,
v.
NVIDIA Corp.; Jen–Hsun Hunag; Marvin D. Burkett, Defendants–Appellees.

No. 11–17708.
|
Argued and Submitted Jan. 14, 2014.
|
Filed Oct. 2, 2014.

Synopsis

Background: Stock purchasers filed class actions alleging that semiconductor company's delay in disclosing product defects in its filings with Securities and Exchange Commission (SEC) violated federal securities laws. After actions were consolidated, the United States District Court for the Northern District of California, Richard Seeborg, J., 2011 WL 4831192, dismissed complaint, and purchasers appealed.

Holdings: The Court of Appeals, O'Connell, District Judge, sitting by designation, held that:

SEC regulation did not create duty to disclose defects in SEC filings, and

purchasers failed to plead strong inference of scienter.

Affirmed.

Attorneys and Law Firms

***1047** David Brower (argued), Brower Piven, New York, NY, for Plaintiffs–Appellants.

James Kramer (argued) and Michael Torpey, Orrick, Herrington & Sutcliffe, LLP, San Francisco, CA, for Defendants–Appellees.

Appeal from the United States District Court for the Northern District of California, Richard Seeborg, District Judge, Presiding. D.C. No. 3:08–cv–04260–RS.

Before: RICHARD C. TALLMAN and SANDRA S. IKUTA, Circuit Judges, and BEVERLY REID O'CONNELL, District Judge. [*]

*1048 OPINION

O'CONNELL, District Judge:

This case involves allegations of securities fraud. Defendant NVIDIA Corporation is a publicly traded semiconductor company. In the spring of 2008, it disclosed to investors information about defects in two of its products. A little over one month later, it further disclosed that it would be taking a \$150–\$200 million charge to cover costs arising from those product defects. As a result, NVIDIA's share price dropped 31% and its market capitalization contracted by \$3 billion. According to Plaintiffs, who had purchased NVIDIA's stock in the preceding eight months, the company knew it would be liable for the defective products long before its 2008 disclosures. They claim that NVIDIA should have informed investors about the defects as early as November 2007. They further contend that, absent a disclosure about the product defects, NVIDIA's intervening statements regarding its financial condition were misleading to investors, and consequently in violation of Section 10(b) of the Securities Exchange Act of 1934 and corresponding Securities Exchange Commission ("SEC") Rule 10b–5.

The district court below dismissed Plaintiffs' amended complaint without further leave to amend, holding that it failed to adequately allege scienter, a necessary element for a claim under either Section 10(b) or Rule 10b–5. We have jurisdiction under 28 U.S.C. § 1291.

On appeal, Plaintiffs essentially raise three distinct arguments, all directed to the element of scienter. First, they argue that the disclosure duty under Item 303 of Regulation S–K, 17 C.F.R. § 229.303, is actionable under Section 10(b) and Rule 10b–5. A proper analysis, they contend, should ascertain whether Defendants acted with scienter in violating Item 303's disclosure duty. Second, Plaintiffs assert that the district court failed to consider their allegations holistically. They contend that, when considered holistically, their allegations give rise to a strong inference of scienter. Third, Plaintiffs argue that the district court erred in finding that neither the corporate scienter doctrine nor the core operations doctrine supports a strong inference of scienter.

For the reasons discussed below, we affirm.

I

A.

NVIDIA Corporation is a publicly traded semiconductor company founded in 1993 by Jen–Hsun Huang, its current CEO. Its core business involves the design and sale of two similar semiconductor chips. One is a graphics processing unit ("GPU"); the other is a media and communications processor ("MCP"). In essence, GPUs are designed to process the vast amount of data necessary to render images to a computer's visual display. MCPs are similar to GPUs in that they function as a GPU in addition to various other devices, such as a system memory interface, Ethernet communications controller, and audio signal processor. Original equipment manufacturers ("OEMs"), such as Hewlett–Packard ("HP") and Dell Computer ("Dell"), purchase these chips and incorporate them into the motherboards of computers they assemble and sell to consumers.

In addition to their similar functions, GPUs and MCPs also share a similar configuration, which comprises two main parts: (1) a "die," or the silicon chip itself; and (2) a "substrate," or wafer, which is a green circuit board that ultimately connects the die to the motherboard's electrical ***1049** components. To manufacture the GPUs and MCPs, the die is mounted onto the substrate. Importantly, the die electronically connects to the substrate through "bumps" of solder that relay electrical signals between the die and the rest of the computer. The bumps are attached to the substrate using a solder paste. Between the die and substrate is an "underfill," which is a glue-like material that acts as an additional bonding agent to fortify the connection between the die and substrate. Together, the solder and underfill are referred to as the "Material Set."

Given the highly complex and technical nature of NVIDIA's GPU and MCP products, there is an inherent risk that some will fail. As a result, NVIDIA routinely includes in its SEC forms a statement explaining that "[its] products may contain defects or flaws," and warning investors that "[it] may be required to reimburse customers for costs to repair or replace the affected products." To cover costs relating to inevitable defects, NVIDIA automatically records a reduction to revenue as a cash **reserve**. As product return and replacement costs accrue, NVIDIA withdraws cash from that **reserve**.

B.

According to the complaint, in September 2006, NVIDIA began experiencing problems with certain of its GPU and MCP products, particularly with those products' Material Set. Plaintiffs allege that some of NVIDIA's chips experienced cracks in the solder bumps when subjected to excessive pressure during product testing. At that time, NVIDIA had been using a "eutectic" solder [1] (which has a relatively low lead content) together with eutectic solder paste. In an attempt to remedy the cracking problem, NVIDIA switched some of the solders used in the chips from a eutectic solder to a high-lead solder, which is more malleable and therefore less susceptible to cracking from the pressure in product testing. It continued to use the eutectic solder paste, however. According to Plaintiffs, varying thermal properties of the new, high-lead solder and the eutectic solder paste contributed to new problems with NVIDIA's chips. Specifically, because the two materials undergo thermal expansion at varying rates, the high-lead solder is susceptible to fatigue and cracking over time.

At some point, these new problems began manifesting in laptop computers incorporating NVIDIA's GPU and MCP products that were made using high-lead solder. After HP (and later Dell) began investigating these problems, it observed new cracking of the solder bumps connecting the die to the substrate (the "Material Set Problem"). At first, NVIDIA attributed the problem to " 'customer-induced damage or [OEM] design issues.' " HP hypothesized that heat cycling was the root cause of the problem. [2] Specifically, HP believed that the solder bumps would weaken over time due to repeated thermal expansion caused by heat cycling.

To reduce the stress on the chips' solder bumps, and thus ameliorate the cracking problem, HP and Dell, with the help of ***1050** NVIDIA, issued software updates ("BIOS"[3] updates) to their laptop computers. These BIOS updates altered a computer's fan algorithm, causing the internal cooling fans to run continuously, thereby eliminating heat cycling. Evidently, HP believed that by maintaining a fairly constant temperature, the solder bumps would not undergo thermal expansion as often and thus not be as susceptible to fatigue and failure.

Ultimately, after significant testing, HP concluded that the root cause of GPU and MCP failures in its computers was not caused by cracking due to heat cycling, but by cracking due to operation of the chips within a narrow temperature range. Apparently, the stress on the solder bumps caused by varying thermal properties of the high-lead solder and eutectic solder paste was especially acute in this temperature range. HP shared with NVIDIA its data demonstrating this problematic thermal profile, and, at some point, NVIDIA reproduced the data in its own laboratories.

In May and June 2008, NVIDIA issued to its OEM customers Product Change Notifications ("PCNs"), indicating that it would be transitioning back to eutectic solder.

C.

Between November 8, 2007, and May 22, 2008, NVIDIA filed several forms with the SEC, as required by law. According to Plaintiffs, those forms contained materially false and misleading statements, principally because they omitted information regarding the Material Set Problem.

For example, in the November 8, 2007 Form 8–K, Plaintiffs point to NVIDIA's claim that "[its] core businesses are continuing to grow as the GPU becomes increasingly central to today's computing experience." In NVIDIA's February 13, 2008 Form 8–K, it highlights the assertion that "Fiscal 2008 was another outstanding and record year for us. Strong demand for GPUs in all market segments drove our growth." Plaintiffs argue that these statements and others made in NVIDIA's March 21, 2008, Form 10–K and May 8, 2008, Form 8–K are materially false and misleading because NVIDIA failed to disclose reported defects in its products as well.

D.

On May 22, 2008, NVIDIA disclosed in its quarterly report that it had received claims for reimbursement from one of its OEMs for incremental costs due to an " 'alleged die/packaging material set defect.' " The report also indicated that the product was included in a significant number of the customer's computer products and had been shipped to other customers in significant quantities. NVIDIA explained that it was "evaluating the potential scope" of the problem "and cause of the alleged defect and the merits of the customer's claim." It further indicated that it was "unable to estimate the amount of costs that may be incurred" at that time.

Just over one month later, on July 2, 2008, NVIDIA filed an SEC Form 8–K indicating it would be taking "a $150 to $200 million charge to cover warranty, repair, return, replacement, and other costs 'arising from a weak die/packaging material set in certain versions of [its] previous MCP and GPU products used in notebook systems.' "[4] After NVIDIA's July 2, 2008 ***1051** disclosure, the market reacted accordingly, causing a 31 % decline in NVIDIA's share price and a decrease of over $3 billion in its market capitalization.

E.

Plaintiffs invested in NVIDIA's stock between November 8, 2007 and July 2, 2008 (the "class period"). They allege that, beginning November 8, 2007, NVIDIA knew of the defect in the GPU and MCP Material Set, this knowledge was material to investors, and failure to disclose it made other statements in NVIDIA's SEC filings misleading.

Believing that Defendants violated federal securities laws, Plaintiffs filed three separate lawsuits, which the district court consolidated into a single action. In the consolidated complaint, Plaintiffs allege three distinct but related counts. In the first and second counts, they allege that NVIDIA and Huang, respectively, are liable for violations of both Section 10(b) of the Securities Exchange Act of 1934 and corresponding SEC Rule 1 0b–5. In the third count, they aver that Huang is further liable for violations of Section 20(a) of the Securities Exchange Act of 1934.

Upon Defendants' motion, the district court dismissed Plaintiffs' first consolidated class action complaint with leave to amend. Plaintiffs then filed a second consolidated class action complaint. Upon a second motion by Defendants, the district court dismissed that complaint without leave to amend. In its order of dismissal, the district court specifically held that Plaintiffs failed to sufficiently plead scienter, an element required for each count.

II

We review dismissals under Federal Rule of Civil Procedure 12(b)(6) de novo. *In re Daou Sys., Inc.,* 411 F.3d 1006, 1013 (9th Cir.2005). In doing so, we accept as true all factual allegations and determine whether they are sufficient to state a claim for relief; we do not, however, accept as true allegations that are conclusory. *Ashcroft v. Iqbal,* 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009). Moreover, "[f]actual allegations must be enough to raise a right to relief above the speculative level." *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 555, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007). There must be "more than a sheer possibility that a defendant has acted unlawfully." *Iqbal,* 556 U.S. at 678, 129 S.Ct. 1937.

In reviewing the sufficiency of a complaint, we limit ourselves to the complaint itself and its attached exhibits, documents incorporated by reference, and matters properly subject to judicial notice. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 322–23, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007); *Lee v. City of Los Angeles,* 250 F.3d 668, 688 (9th Cir.2001).

III

A.

1.

Section 10(b) of the Securities Exchange Act of 1934 declares it unlawful to "use or employ, in connection with the purchase or sale of any security ..., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary." 15 U.S.C. § 78j(b). As the Supreme Court has indicated, there is an ***1052** "implied [ ] private cause of action" in Section 10(b). *Matrixx Initiatives, Inc. v. Siracusano,* ––– U.S. ––––, 131 S.Ct. 1309, 1317, 179 L.Ed.2d 398 (2011). Additionally, "SEC Rule 10b–5 implements [Section 10(b)] by making it unlawful to ... 'make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made ... not misleading.' " *Id.* (quoting 17 C.F.R. § 240.10b–5). Thus, to prevail on a claim for violations of either Section 10(b) or Rule 10b–5, a plaintiff must prove six elements: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc.,* 552 U.S. 148, 157, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008).

Section 20(a) of the Securities Exchange Act of 1934 provides for liability of a "controlling person." 15 U.S.C. § 78t(a). To establish a cause of action under this provision, a plaintiff must first prove a primary violation of underlying federal securities laws, such as Section 10(b) or Rule 10b–5, and then show that the defendant exercised actual power over the primary violator. *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1065 (9th Cir.2000). Accordingly, our analysis focuses on Plaintiffs' allegations under Section 10(b) and Rule 10b–5.

2.

When alleging violations of federal securities laws, a plaintiff must satisfy the pleading requirements pronounced in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *Zucco Partners, LLC v. Digimarc Corp.,* 552 F.3d 981, 990–91 (9th Cir.2009). In passing this act, Congress "significantly altered pleading requirements in securities fraud cases [by] ... requir[ing] that a complaint plead with particularity both falsity and scienter." *Id.* at 990 (internal citations and quotation marks omitted). More precisely, now a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2)(A).

To assist courts in determining whether a plaintiff has satisfied this heightened pleading standard, the Supreme Court has provided three points of instruction: (1) "courts must, as with any [12(b)(6)] motion to dismiss ..., accept all factual allegations in the complaint as true"; (2) "courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss"; and (3) "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." *Tellabs,* 551 U.S. at 322–23, 127 S.Ct. 2499. In discussing the third point, the Court explained that, although "[t]he inference [of scienter] need not be irrefutable, ... or even the 'most plausible of competing inferences,' " it "must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other [countervailing] explanations." *Id.* at 324, 127 S.Ct. 2499 (citations omitted). Ultimately, the Court held that "[a] complaint will survive ... only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.*

3.

Having outlined the lens through which we must consider Plaintiffs' allegations of ***1053** scienter, we now turn to the definition of scienter itself. In *Ernst & Ernst v. Hochfelder,* the Supreme Court explained in a footnote that "the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. 185, 193 n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). The Court recognized that some Courts of Appeals include within their definition of scienter a form of recklessness, but it did not address whether those courts are correct in doing so.*Id.* As recently as in its decision in *Matrixx Initiatives,* the Court stated that it "ha[s] not [yet] decided whether recklessness suffices to fulfill the scienter requirement." 131 S.Ct. at 1323.

In this circuit, we have "held that recklessness may satisfy the element of scienter." *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1568–69 (9th Cir.1990) (en banc). We defined recklessness " 'as a highly unreasonable omission, involving ... an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.' " *Id.* at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.2d 1033, 1044–45 (7th Cir.1977)). [5] We added that "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing." *Id.* at 1569–70 (internal quotation marks omitted). In *In re Silicon Graphics Inc. Securities Litigation,* we opined that the wording of our previous decisions discussing recklessness—including our decision in *Hollinger*—indicates that the standard for recklessness is actually much closer to one of intent: "These cases indicate that recklessness only satisfies scienter under § 10(b) to the extent that it reflects some degree of intentional or conscious misconduct." 183 F.3d 970, 977 (9th Cir.1999). Accordingly, we explained that scienter requires "a strong inference of, at a minimum, *'deliberate* recklessness.' " *Id.* (emphasis added). [6] Since then, we have consistently applied the "deliberate recklessness" terminology and standard articulated in *Silicon Graphics. See, e.g., In re VeriFone Holdings, Inc. Sec. Litig.,* 704 F.3d 694, 702 (9th Cir.2012); *Zucco Partners,* 552 F.3d at 991; *In re Daou Sys., Inc.,* 411 F.3d at 1022. [7]

We now address Plaintiffs' arguments on appeal.

B.

Plaintiffs first argue that the district court erred by failing to consider their ***1054** allegations of scienter in the context of Item 303 of Regulation S–K, 17 C.F.R. § 229.303. [8] They correctly assert that Item 303 requires disclosure of certain information. But then they contend that, if the information is material, failure to disclose it constitutes a material omission for purposes of Section 10(b) and Rule 10b–5. Ultimately, Plaintiffs argue that the district court's analysis should have focused on whether NVIDIA acted with scienter in failing to make the Item 303 disclosure.

We have never directly decided whether Item 303's disclosure duty is actionable under Section 10(b) and Rule 10b–5. We now hold that it is not.

To prevail on a claim under Section 10(b) or Rule 10b–5, a plaintiff must demonstrate that the defendant made a misleading statement or omission of material fact. *Matrixx Initiatives,* 131 S.Ct. at 1318. Thus, a statement might be misleading because it affirmatively misstates information. Or a statement might be misleading because it is made outside the context of other material information. Yet neither Section 10(b) nor Rule 10b–5 "create[s] an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary 'to make ... statements made, in the [sic] light of the circumstances under which they were made, not misleading.' " *Id.* at 1321–22 (alteration in original) (quoting 17 C.F.R. § 240.10b–5). In *Basic Inc. v. Levinson,* the Supreme Court noted that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b–5." 485 U.S. 224, 239 n. 17, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). The Court did not explain what would give rise to a duty to disclose, but it is this language in *Basic* that Plaintiffs cite in support of their argument. They assert that Item 303 creates "a duty to disclose," and failure to disclose it is therefore misleading for purposes of Section 10(b) and Rule 10b–5.

We have confronted a similar argument before. *See In re VeriFone Sec. Litig.,* 11 F.3d 865, 870 (9th Cir.1993); *In re Lyondell Petrochemical Co. Sec. Litig.,* 984 F.2d 1050, 1053 (9th Cir.1993); *In re Convergent Techs. Sec. Litig.,* 948 F.2d 507, 516 (9th Cir.1991). In each instance, we strongly suggested that a violation of Item 303 cannot be used to show a violation of Section 10(b) and Rule 10b–5. We noted that, "[w]hile § 229.303(a)(3)(ii) provides that 'known trends or uncertainties' be disclosed in certain SEC filings," Instruction 7 to Item 303(a) "states that forward-looking information need not be disclosed." *In re VeriFone,* 11 F.3d at 870. Without further discussion, we rejected the plaintiffs' argument. [9]

In *Oran v. Stafford,* the Third Circuit decided this issue more directly. 226 F.3d 275, 287–88 (3d Cir.2000). We are persuaded by its reasoning. There, the court explained that Item 303's disclosure requirement "varies considerably from the general test for securities fraud materiality set out by the Supreme Court in *Basic* ***1055** *Inc. v. Levinson.*" *Id.* at 288. In relevant part, Item 303 requires corporate management to "[d]escribe [in 10–K and 10–Q forms] 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." 17 C.F.R. § 229.303(a)(3)(ii). The SEC shed further light on this requirement in an interpretive release:

> Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:
>
> (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.

Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34–26831, 54 Fed.Reg. 22427, 22430 (May 24, 1989). On the other hand, in *Basic,* the Supreme Court stated that materiality of forward-looking information depends "upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." 485 U.S. at 238, 108 S.Ct. 978 (internal quotation marks omitted).

As the court in *Oran* also determined, these two standards differ considerably. 226 F.3d at 288. Management's duty to disclose under Item 303 is much broader than what is required under the standard pronounced in *Basic.* The SEC intimated this point as well: "[Item 303] mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure—*i.e.,* reasonably likely to have a material effect.... The probability/magnitude test for materiality approved by the Supreme Court in *Basic, Inc., v. Levinson,* 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988), is inapposite to Item 303 disclosure." Exchange Act Release No. 34–26831, 54 Fed.Reg. at 22430 n. 27. The SEC's effort to distinguish *Basic* 's materiality test from Item 303's disclosure requirement provides further support for the position that Item 303 requires more than *Basic*—what must be disclosed under Item 303 is not necessarily required under the standard in *Basic.* Therefore, "[b]ecause the materiality standards for Rule 1 0b5 and [Item 303] differ significantly, the '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. Such a duty to disclose must be separately shown.' " *Oran,* 226 F.3d at 288.

Plaintiffs' reliance on *Litwin v. Blackstone Group, L.P.,* 634 F.3d 706 (2d Cir.2011), and *Panther Partners Inc. v. Ikanos Communications, Inc.,* 681 F.3d 114 (2d Cir.2012), is unavailing. Those cases involved alleged violations of Sections 11 and 12(a)(2) of the Securities Act of 1933, not Section 10(b) or Rule 10b–5. And, as we acknowledged in *Steckman v. Hart Brewing, Inc.,* "Section 10(b) of the Exchange Act ... differs significantly from Sections 11 and 12(a)(2) of the Securities Act." 143 F.3d 1293, 1296 (9th Cir.1998). Liability under Sections 11 and 12(a)(2) of the Securities Act may arise from "omitt[ing] to state a material fact required to be stated." *See*15 U.S.C. §§ 77k(a), 77***l***(b). To put it differently, liability arises from "an ***1056** omission in contravention of an affirmative legal disclosure obligation." *Panther Partners,* 681 F.3d at 120. There is no such requirement under Section 10(b) or Rule 10b–5. As discussed above, for purposes of Section 10(b) and Rule 10b–5, material information need not be disclosed unless omission of that information would cause other information that is disclosed to be misleading. *Matrixx Initiatives,* 131 S.Ct. at 1321. Furthermore, as noted in *Panther Partners,* scienter is not an element of either a Section 11 or Section 12(a)(2) claim. 681 F.3d at 120. Such claims are not subject to the PSLRA's heightened pleading standards unless based on allegations of fraud. *Id.* Accordingly, neither *Panther Partners* nor *Litwin* affects our analysis here.

Also unavailing is Plaintiffs' reliance on *Simon v. American Power Conversion Corp.,* 945 F.Supp. 416 (D.R.I.1996). In that case, then-Chief Judge Laguex opined that Item 303 imposes "an affirmative duty to disclose," and found that the defendant's failure to disclose in that case was actionable. *Simon,* 945 F.Supp. at 431. Subsequently, however, Judge Laguex clarified his opinion: "As this Court noted in *Simon,* the disclosure rules are probative of what defendants are otherwise obliged to disclose but do not, themselves, provide an independent duty of disclosure." *Kafenbaum v. GTECH Holdings Corp.,* 217 F.Supp.2d 238, 249 (D.R.I.2002). He went on to say that "plaintiffs may not rely solely upon Item 303 to prove that defendants failed to disclose material information as a matter of law [in violation of Rule 10b–5]." *Id.* at 250.

In sum, we hold that Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b–5. Such a duty to disclose must be separately shown according to the principles set forth by the Supreme Court in *Basic* and *Matrixx Initiatives.*

C.

Next, Plaintiffs contend that the district court erred by not considering their allegations of scienter holistically.

In *Tellabs,* the Supreme Court explained that, when assessing allegations of scienter, a "court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically.... [T]he reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" 551 U.S. at 326, 127 S.Ct. 2499 (citations omitted). We apply this same standard but in a dual inquiry. First, we determine whether any of the plaintiff's allegations, standing alone, is sufficient to create a strong inference of scienter. *Zucco Partners,* 552 F.3d at 992. If none is sufficient alone, we then consider the allegations holistically to determine whether they create a strong inference of scienter taken together. *Id.*

We have reviewed Plaintiffs' allegations in their entirety. We find that none creates a strong inference of scienter individually. And, together, they do not give rise to a strong inference of scienter holistically. The most compelling inference that we can reasonably draw is that NVIDIA was first investigating the root cause, and then the scope, of the Material Set Problem; once it determined that its liability would exceed its normal reserves, NVIDIA disclosed the problem to investors. Any inference of scienter requires more than this. Thus, while the complaint may plausibly allege knowledge of the Material Set Problem, it does not plausibly allege that NVIDIA and Huang intentionally misled investors, or acted with deliberate ***1057** recklessness, by not disclosing the problem sooner. We discuss our reasoning below.

Plaintiffs contend that NVIDIA acted with scienter in withholding from investors certain information regarding the Material Set Problem. They allege that, between November 2007 and July 2008, NVIDIA made various statements in its SEC forms regarding its financial performance and the quality of its products. Plaintiffs argue that those statements were materially false and misleading because NVIDIA did not also disclose that certain of its products were failing at an abnormal rate and that NVIDIA ultimately would be financially responsible for replacement costs. According to Plaintiffs, NVIDIA first determined that it would be financially liable for the chip failures by the middle of 2007; nevertheless, it did not disclose this to investors until July 2008. From these facts, Plaintiffs infer that NVIDIA intentionally misled investors by waiting to disclose its liability for almost an entire year, until it had prepared replacement products.

In evaluating Plaintiffs' inference of scienter, we bear in mind that NVIDIA includes in its SEC forms a statement explaining that "[its] products may contain defects or flaws" and warning investors that "[it] may be required to reimburse customers for costs to repair or replace the affected products." Moreover, we are mindful that, because product defects are so common, NVIDIA automatically records a reduction to revenue as a cash **reserve** to cover costs relating to the inevitable product failures. Bearing these facts in mind, we must determine whether Plaintiffs' allegations create a strong inference of scienter that Huang and NVIDIA intentionally misled investors, or were at least deliberately reckless, by not disclosing NVIDIA's liability for chip failures prior to July 2008.

1.

Plaintiffs allege that NVIDIA first became aware of the Material Set Problem sometime in 2006, and then determined the root cause of the problem—and therefore that it would be financially responsible for it—by the middle of 2007. Then they contend that the one-year delay between NVIDIA's root cause determination in mid–2007 and its disclosure of the problem in 2008 was motivated by an intent to mislead investors until it had prepared replacement products. Nevertheless, Plaintiffs' allegations that NVIDIA first determined the root cause of its chip failures by the middle of 2007 are implausible. In so alleging, Plaintiffs rely most directly on the accounts of Confidential Witness No. 1 ("CW1"), Confidential Witness No. 7 ("CW7"), and articles written by Charlie Demerjian.

According to CW1, " 'communications between HP and NVIDIA began in 2006, with HP asking questions, and asking NVIDIA to conduct [a] failure analysis.' " When NVIDIA initially resisted, HP began to engage it at a higher, executive, level. By early 2007, HP had determined that NVIDIA's chips sustained physical damage through normal use, and therefore making NVIDIA responsible. HP developed " 'overwhelming data demonstrating root cause' " and "identified the thermal profile" that would cause NVIDIA's chips to experience cracking at the solder bumps. CW1 asserts that HP shared the data and thermal profile with NVIDIA sometime in early 2007 and NVIDIA reproduced it by the middle of 2007.

The timing of CW1's account conflicts with the account of Richard Hunt Hodge, HP's Director of Engineering and Quality ***1058** for the Notebook Division. [10] According to Hodge, HP itself did not determine the thermal profile that would significantly increase the probability of chip failures until the middle of 2008: "Ultimately, by mid–2008, HP determined that operation of the NVIDIA part through a narrow temperature range ... was the cause of" chip failures due to solder bump cracking. If HP did not determine the problematic thermal profile until the middle of 2008, any inference of scienter is significantly reduced, as NVIDIA disclosed the information in July 2008.

The notion that HP had determined the problematic thermal profile in early 2007 is implausible when considered together with Plaintiffs' other allegations. Plaintiffs allege that HP and Dell, with the help of NVIDIA, issued BIOS updates in November 2007 [11] and February 2008, respectively. Those BIOS updates altered a computer's fan algorithm so that its internal cooling fans would run continuously, thereby eliminating heat cycling and maintaining a fairly constant temperature inside the computer. Hodge explains in his declaration that the HP BIOS update "keeps [a GPU or MCP] outside of [the problematic] temperature range (usually around 50°C at idle). Because it runs constantly, it obviates the thermal mini-cycle through the problematic narrow temperature range." If HP had determined the problematic thermal profile in early 2007, as Plaintiffs and CW1 allege, it is implausible that HP would have waited until November 2007 to issue a BIOS update that greatly reduces the probability of a chip failure due to solder bump cracking. [12] The implausibility of the timing in CW1's account of events further detracts from any inference of scienter.

Plaintiffs' reliance on Charlie Demerjian and CW7 to corroborate CW1's timing of events does not restore plausibility to their allegations. Demerjian is “a reporter with 25 years experience working with computers.” He “covered NVIDIA's chip defects and spoke to dozens of people about the problems.” Clearly, Demerjian's information is secondhand. In any event, Demerjian merely indicates that “HP started a ‘root cause analysis' and by summer 2007, HP employees knew that NVIDIA's GPUs were having problems associated with heat cycling.” This account does not indicate that HP had determined the root cause or problematic thermal profile by summer 2007. According to CW7, “Dell saw problems with NVIDIA GPUs in early 2007.” CW7 indicated that NVIDIA “eventually admitted that it was their chip causing the ***1059** problem, and that it was not a Dell issue.” Nevertheless, CW7 does not allege when NVIDIA admitted responsibility for the problems. Thus, even if Dell had notified NVIDIA of problems in early 2007, CW7 provides no basis to infer that NVIDIA also knew it would be liable at that time.

Even accepting as true CW1's timing of events, the fact that NVIDIA had reproduced the problematic thermal profile by the middle of 2007—and thus had determined the root cause of the chip failures—does not create an inference of scienter. Plaintiffs assert that HP provided NVIDIA with what HP believed demonstrated root cause of, and NVIDIA's liability for, the chip failures. Their allegations do not provide any basis to infer what NVIDIA concluded from the profile or other data, nor do they plausibly suggest that NVIDIA must have determined it was at fault at that time. Furthermore, Plaintiffs never allege that Huang or anyone else at NVIDIA knew at that time (or any time prior to July 2008) that NVIDIA's liability would exceed its normal **reserve** set aside for costs associated with product failures. Accordingly, these allegations do not give rise to a strong inference that Huang and NVIDIA acted with intent to mislead investors, or recklessly disregarded an obvious danger of misleading investors, by not disclosing information regarding the Material Set Problem prior to July 2008.

2.

After alleging that HP provided NVIDIA with all of its data demonstrating root cause and the problematic thermal profile, Plaintiffs assert that determining the cause of the problem should have been easy for NVIDIA. They rely on several sources to support this allegation.

CW1, Demerjian, and John Rigg, Plaintiffs' consultant in this case, assert that “failures of the GPU are easily identifiable.” Confidential Witness No. 2 explains that it “takes about a month” to determine whether a GPU or MCP is generating more heat than specified. Hodge indicates that “it took HP less than two months to hypothesize that temperature cycling caused the problematic cracks in the solder bumps.”

But even if GPU failures are easily identifiable, it does not necessarily follow that NVIDIA would be responsible for those failures or should have known that it would be responsible. As NVIDIA initially contended, the failures could have been caused by OEM design issues. And Plaintiffs' reliance on Hodge's declaration for the contention that NVIDIA should have easily determined that it was liable for the chip failures is misplaced. Plaintiffs ignore the timing of Hodge's account—HP did not hypothesize temperature mini-cycling as the root cause until November 2007. Then, HP did not begin to test its hypothesis until January 2008. After 13 weeks of testing, HP determined that temperature mini-cycling was not the root cause, as its testing did not induce a single chip failure. It was not until sometime around the middle of 2008 that HP ultimately discovered the specific cause of chip failures: operation within the problematic thermal profile.

Plaintiffs also rely on two articles for the proposition that NVIDIA must have known that it was going to be liable sooner than it admitted. Both articles were published after NVIDIA's July 2008 disclosure. One article provides AMD's (one of NVIDIA's competitors) opinion on NVIDIA's chip failures. “According to the article, ‘AMD thinks [high-lead bumps are] more prone to fatigue and need “comprehensive reliability engineering to be used successfully.” ’ ” AMD also notes that a high-lead solder and eutectic solder paste have varying thermal expansion coefficients, ***1060** which places significant stress on the solder bumps. The other article discusses a research report written by K.N. Tu, a professor affiliated with the Department of Materials Science and Engineering at the University of California, Los Angeles. In essence, the report discusses the same issues discussed by AMD.

These articles do not contribute to an inference of scienter. They were written in hindsight and do not reflect Huang or NVIDIA's knowledge prior to July 2008. Simply because scientists were able to explain in retrospect the science behind NVIDIA's chip failures, it does not mean that NVIDIA knew or should have known it would be liable for those failures during the class period or that its liability would exceed its normal **reserve**.

Plaintiffs also point to an email authored by HP's Richard Hodge in May 2007, wherein Hodge indicated that NVIDIA had moved away from eutectic solder in its chips. From this email, Plaintiffs conclude that there are "known industry concerns with ... the use of high-lead solder." They also conclude, "Defendants knew and/or deliberately disregarded that their GPU and MCP problems likely stemmed from this hasty, under-tested manufacturing change initiated in 2006." Nevertheless, there is no basis for this conclusion. Certainly, Hodge's email suggests that he had some concern about using noneutectic solder. But there is nothing more to indicate an industry-wide concern with noneutectic solder, nor is there anything to suggest that NVIDIA should have known that its use of noneutectic solder was the root cause of its chip failures. Accordingly, this allegation does not appreciably add to any inference of scienter.

3.

Next, Plaintiffs contend that NVIDIA delayed disclosure of its chip failures until it had prepared replacement chips. They support this contention with very few factual allegations, however.

Plaintiffs rely on statements made by CW1. After HP provided NVIDIA with data that HP believed demonstrated the root cause of the chip failures and the problematic thermal profile that would cause those failures, " 'NVIDIA confirmed to HP that it was able to reproduce the problem.' " Yet, according to CW1, NVIDIA " 'never admitted to getting to root cause, and they peddled the same story for as long as possible, that they were still investigating.' " CW1 also alleges that "NVIDIA would do the 'PhD runaway' to appear cooperative while trying to slow HP down." In essence, CW1 asserts that NVIDIA's Ph.D. employees would ask HP to conduct additional tests merely to buy more time.

As we discussed above, the timing of CW1's account is implausible, especially in light of Hodge's more-detailed declaration. CW1 provides no specific examples of when NVIDIA attempted to slow down HP by having it conduct meaningless tests or experiments, nor does CW1 explain why those tests and experiments were meaningless. From CW1's assertions alone, a reasonable factfinder could not infer that NVIDIA was conducting needless testing or attempting to delay disclosure of its product defects. As a matter of law, CW1's account to this end does not add to an inference of scienter.

Plaintiffs also rely on a statement made by NVIDIA's Vice President of Investor Relations, Michael Hara. In September 2008, after NVIDIA's disclosure, Hara explained to investors that the failing chips were past or near the end of their useful life and that NVIDIA was " 'not even shipping these parts anymore.' " From this statement, Plaintiffs infer that "Defendants stalled the disclosure of the material, ***1061** adverse facts for several months, if not a full year, until the failing products were at the end of their life-cycle and the Company had new products to market."

We agree that the coincidence of NVIDIA's disclosure with the apparent end-of-life of its failing chips could, under some circumstances, arouse suspicion. But this statement alone does not create an inference that NVIDIA strategically delayed disclosure of its chip failures until those chips were past their useful life.

Finally, Plaintiffs rely on the fact that NVIDIA participated in preparation of BIOS updates and issued PCNs. As we discussed above, the uncontested evidence shows that in November 2007, NVIDIA helped HP (and later Dell) issue BIOS software updates that altered a computer's fan algorithm. In May and June 2008, NVIDIA issued PCNs that indicated it would be changing back to a eutectic solder in its GPUs and MCPs. Plaintiffs allege that significant engineering is required to transition from one Material Set to another. From these facts, Plaintiffs conclude that NVIDIA must have known it was liable for the product defects long before its disclosure. But these facts do not mandate such a conclusion. The

BIOS updates were intended to ease stress caused by heat cycling, which, as NVIDIA first contended, could have been caused by OEM design issues. Even if NVIDIA decided to transition back to eutectic solder long before it issued PCNs in May and June 2008, it does not necessarily mean that NVIDIA knew it was responsible for the failures. A more plausible inference is that NVIDIA believed that high-lead solder was a contributing factor and switched back to eutectic solder to eliminate it.

4.

After alleging that NVIDIA delayed disclosure until it had prepared replacement chips, Plaintiffs attempt to buttress that allegation by contending that NVIDIA has a history of delaying disclosure of known problems. Nevertheless, they rest their contention on the accounts of several confidential witnesses whose experiences do not contribute to an inference of scienter. Their accounts are unspecific and speculative. More problematic, some witnesses never worked for NVIDIA. And those who did either stopped working there long before the Material Set Problem arose or worked in an area unrelated to it, such as environmental engineering or "Staffing Systems and Compliance."

For example, Confidential Witness No. 11 ("CW11") worked for NVIDIA as a senior engineering manager between December 2002 and March 2006, months before the product failures arose. CW11's declaration maintains that NVIDIA is "arrogant, [and] think[s it] never do[es] wrong," and "operated with a 'failure to recognize real problems.' " Confidential Witness No. 12 ("CW12") was a sales director for one of NVIDIA's vendors. CW12 "stated that NVIDIA was notorious for blaming other entities for product related problems.... 'Some of the time they were right in [blaming others] and some of the time they were wrong, but their default was always to say, "This is not our problem. This is your problem." ' "

Confidential Witness No. 13 ("CW13") worked at NVIDIA as an environmental compliance engineer. CW13 "stated that NVIDIA has a history of failing to take responsibility for Company problems." CW13 believes that NVIDIA " 'had the following mentality: "Don't say anything to muck the waters." ' " " '[Confidential Witness No. 15 ("CW15")], a former NVIDIA Staffing Systems and Compliance Analyst, stated that s/he was told: "I don't care what you do, just make us look good." ' " CW15 provides no context, however, ***1062** as to who made the statement or why the statement was made. Confidential Witness No. 16 ("CW16") worked for a website that sold NVIDIA products. CW16 stated, " 'I've seen a lot of hostile actions from [NVIDIA] ... 'NVIDIA tends to be a little "scrooge-ish" when it comes to scrapping their failure percentage rates.... They've had a lot of fiascos in the past with like the GeForce 2 Ultra, a lot of overheating issues.' "

These statements do not give rise to an inference of scienter individually. The testimony of Confidential Witness No. 14 ("CW 14") provides the most probative evidence indicating that NVIDIA had a culture of failing to take responsibility for known problems. CW14 was a "Director of IC Quality and Reliability for NVIDIA." According to CW14, there was an instance where employees at NVIDIA knew of a design flaw in one of its products, but did not reveal it until after NVIDIA's customer had discovered and contained the problem. CW14's testimony is less significant, however, when considering that his/her period of employment was at most one year, from 2000 to 2001, long before the product defects giving rise to this lawsuit.

Accordingly, these allegations that NVIDIA has a history of delaying known problems do not give rise to a strong inference of scienter.

5.

As further evidence of scienter, Plaintiffs rely on the existence of other lawsuits filed against NVIDIA by its insurers. Apparently, after it disclosed to investors information regarding its defective products, NVIDIA submitted claims to its insurance companies to cover the losses sustained as a result. Foreseeably, the insurance companies did not want to pay NVIDIA's claims. Thus, they alleged that NVIDIA knew of the defective products before January 2008 and had failed to provide information that the insurers had requested. These allegations do not significantly add to an inference of scienter, as the insurers litigating claims would attempt to avoid liability.

Evidently, one of NVIDIA's insurers also alleged the existence of a class action lawsuit filed against HP in November 2007. The insurer argued that NVIDIA knew the lawsuit related to problems with NVIDIA's defective chips and that HP would seek indemnification from NVIDIA. Nevertheless, Plaintiffs never explain with any particularity when or how NVIDIA became aware that HP would seek indemnification from NVIDIA. Accordingly, the existence of this additional lawsuit does not add to an inference of scienter.

6.

Plaintiffs also contend that, when considered with all other allegations, the departure of some of NVIDIA's executives adds to the inference of scienter. We do not agree.

Plaintiffs allege that three individuals left NVIDIA after it disclosed the defective products. On May 27, 2008, NVIDIA's CFO, Marvin Burkett, announced his retirement. Significantly, Burkett continued as interim CFO until a replacement was hired, and in February 2009, he became a senior advisor to NVIDIA. In June 2008, NVIDIA's Senior Director and Head of Internal Audit left the company. Plaintiffs do not explain, however, how this executive played any role in allegedly delaying the disclosure of the defective products. In January 2009, NVIDIA replaced David Kirk, its Chief Scientist. Plaintiffs fail to provide any detail as to why Kirk was replaced; notably, Kirk continued to work with NVIDIA as a research fellow.

In short, Plaintiffs fail to provide any facts to connect these departures with the ***1063** problems at issue in this lawsuit. More detrimental to their allegations, however, is that two of the three individuals remained at NVIDIA in some type of advisory role. Therefore, the most reasonable inference is that these departures were benign.

7.

Plaintiffs argue that their allegations give rise to an inference of scienter under the corporate scienter doctrine. " 'In most cases, the most straightforward way to raise [an inference of scienter] for a corporate defendant will be to plead it for an individual defendant.' " *Glazer Capital Mgmt., LP v. Magistri,* 549 F.3d 736, 743 (9th Cir.2008) (quoting *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.,* 531 F.3d 190, 195 (2d Cir.2008)). Yet, the collective scienter (or corporate scienter) doctrine recognizes that it is possible to raise the inference of scienter without doing so for a specific individual. *Id.* In the Ninth Circuit, we "ha[ve] not previously adopted a theory of collective scienter." *Id.* at 744. Nevertheless, in *Glazer Capital,* we opined that the doctrine might be appropriate in some cases. *Id.* "For instance, as outlined in the hypothetical posed [by the Seventh Circuit], there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication." *Id.* (citing *Makor Issues & Rights, Ltd. v. Tellabs Inc.,* 513 F.3d 702, 710 (7th Cir.2008)).

We do not believe the facts alleged in this case would give rise to an inference of scienter under the collective scienter doctrine. Here, Plaintiffs contend that statements made by NVIDIA in its SEC filings were misleading because NVIDIA did not also disclose information regarding the Material Set Problem. Those statements were not "so dramatically false"—as in the example posed by the Seventh Circuit in *Makor* [13]—to create an inference of scienter that at least some corporate officials knew of the falsity upon publication.

Plaintiffs also contend that their complaint raises a strong inference of scienter under the core operations doctrine. Under this doctrine, the PSLRA's pleading requirements may be satisfied, in certain circumstances, by "a scienter theory that infers that facts critical to a business's 'core operations' or an important transaction are known to a company's key officers." *S. Ferry LP, No. 2 v. Killinger,* 542 F.3d 776, 783–84 (9th Cir.2008). In *South Ferry,* we explained that, in light of the Supreme Court's decision in *Tellabs,* the core operations inference may be considered when weighing a complaint's allegations of scienter holistically. *Id.* at 784–85. Nevertheless, we cautioned that, " 'absent some additional allegation of specific information conveyed to management and related to the fraud' or other allegations supporting scienter," the core operations inference will generally fall short of a strong inference of scienter. *Id.* We did, however, leave open the possibility that "in some unusual circumstances, the core operations inference, without more, may raise the strong inference required by the ***1064** PSLRA." *Id.* at 785. One example of such unusual circumstances is "where the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter."*Id.* at 786.

Here, Plaintiffs never plausibly allege that specific information was conveyed to Huang[14] or others in NVIDIA's management team. They apparently attempt to do so by relying on the account of CW1, but CW1 lacks personal knowledge of these facts. "CW1 report[s] that the communications regarding the [chip] problems were conducted at a high-level [sic]: 'These were executive level guys.' " CW1's "boss was a senior technical employee, a Director of Quality." " 'This guy is not going to be communicating with guys that are at manager level or engineering level.' " From this statement, it is evident that CW1 does not actually know whom from NVIDIA his/her boss communicated with regarding the chip failures. CW1 surmises that, based on his/her boss's status in HP's corporate hierarchy, he was communicating with executive level personnel from NVIDIA. Accordingly, CW1 does not appear to have the requisite personal knowledge to assert that NVIDIA's management team received specific information regarding the defective products.

Even assuming CW1 did have personal knowledge that his/her boss communicated with NVIDIA's executive-level personnel, the specific information allegedly conveyed related to chip failures, not the root cause of them or NVIDIA's liability. As we discussed above, CW1's assertion that HP had determined the root cause in early 2007 is not plausible.

Again, even assuming HP had determined the root cause in early 2007, Plaintiffs do not allege any facts to support the notion that anyone at NVIDIA arrived at the same conclusion as HP regarding the root cause, or that NVIDIA would be liable. Nor do Plaintiffs provide a basis to infer that anyone at NVIDIA was aware that its financial liability would exceed its normal **reserves**. Plaintiffs argue that "[k]nowledge of the financial impact of the chip defect should be presumed when the nature of the problem concerned [NVIDIA's] flagship product and was cause for concern to [NVIDIA's] two largest customers." We do not agree. Without factual allegations showing that at least someone at NVIDIA had knowledge of the extent of NVIDIA's liability, there is no basis to presume that NVIDIA's management would have had such knowledge.

Accordingly, neither the collective scienter doctrine nor the core operations doctrine alone gives rise to a strong inference of scienter.

* * *

Having evaluated Plaintiffs' allegations individually, we find that none creates a strong inference of scienter alone. Evaluating the allegations together, we find that they do not create a strong inference of scienter collectively. The most that a reasonable factfinder could infer from Plaintiffs' allegations is that NVIDIA was aware that some versions of its GPUs and MCPs were experiencing problems sometime in late 2006 or early 2007. At some point, HP determined the thermal profile that increased the probability that NVIDIA's chips would fail due to cracking at the solder bumps. HP shared with NVIDIA ***1065** the thermal profile and other data that it believed demonstrated NVIDIA's liability. NVIDIA evidently reproduced these data and thermal profile yet contested that it was at fault for the chip failures. While Plaintiffs infer that NVIDIA was merely delaying disclosure until it had prepared replacement chips, this is not a cogent and compelling inference. NVIDIA indicated in May 2008 (and even in July 2008) that it had not yet determined the root cause of the product failures, although it evidently was working on a solution. Plaintiffs provide no factual basis to discount those statements. Moreover, product flaws are very common in the semiconductor industry, and NVIDIA regularly takes measures to account for this, as reflected in its disclosures. It warns investors of this possibility and sets aside a **reserve** to account for costs related to those flaws. Although there is some slight support for an inference that NVIDIA knew it was responsible for the problem before its disclosure, and thus acted with intent to deceive at least customers if not investors, a more compelling inference is that NVIDIA did not disclose because it was investigating the extent of the problem, whether it was responsible for it, and if so, whether it would exhaust the **reserve**. Accordingly, we hold that the complaint's allegations do not give rise to a strong inference of scienter when considered holistically. *See Tellabs,* 551 U.S. at 324, 127 S.Ct. 2499.

On appeal, Plaintiffs argue that the Supreme Court has rejected the "inference that defendants were delaying disclosure while 'investigating the scope of the issue.' " It is true that, in *Matrixx Initiatives,* the Supreme Court rejected the assertion that " 'the most cogent inference regarding [the defendant's] state of mind is that it delayed releasing information regarding [a product defect] in order to provide itself an opportunity to carefully review all evidence.' " *Matrixx Initiatives,* 131 S.Ct. at 1324 n. 15. Yet the Court also "d[id] not doubt that this may be the most cogent inference in some cases." *Id.* In *Matrixx Initiatives,* the defendant was a pharmaceutical company that manufactured and sold Zicam, an over-the-counter remedy for the common cold. *Id.* at 1313–14. At some point, a doctor began giving public presentations indicating that Zicam was a flawed product and posed dangerous health risks to its users. *Id.* at 1316. In response to these presentations, the defendant "issued a press release that suggested that studies had confirmed" that Zicam was not flawed. *Id.* at 1316, 1324. Nevertheless, the defendant's press release was false, as no such studies existed. *Id.* at 1324. Accordingly, the Court held that "the misleading nature of [the defendant's] press release is sufficient to render the inference of scienter at least as compelling as the inference [that the defendant was investigating the evidence]." *Id.* at 1324 n. 15.

Here, there are no similar facts. There is no allegation that the issue of an inherent defect in NVIDIA's Material Set was ever publicly raised prior to NVIDIA's disclosure, nor is there any allegation that NVIDIA knowingly issued a false press release, attempting to discount any public discussion regarding its chips' defects. As such, we reject Plaintiffs' assertion that *Matrixx Initiatives* forecloses the inference that NVIDIA delayed disclosure while it investigated the cause of the chip defects and the extent of its liability.

IV

For the reasons discussed above, we affirm the district court's judgment in its entirety.

AFFIRMED.

All Citations

768 F.3d 1046, Fed. Sec. L. Rep. P 98,212, 14 Cal. Daily Op. Serv. 11,522, 2014 Daily Journal D.A.R. 13,509

Footnotes

* The Honorable Beverly Reid O'Connell, United States District Judge for the Central District of California, sitting by designation.

1 Solder is a compound mixture of lead and tin. A particular mixture has a "eutectic" composition if it has a specific ratio of lead to tin. *See* Donald Askeland & Wendelin Wright, Essentials of Materials Science & Engineering 359–63 (2013).

2 Heat cycling is a fluctuation of a computer's internal temperature. As the computer's internal components generate heat from usage, the internal temperature rises. When the computer's sensors detect a certain, preprogrammed temperature, the computer's program activates internal fans to lower the temperature.

3 BIOS stands for Basic Input/Output System.

4 Nevertheless, the form also stated that NVIDIA had "not been able to determine a root cause for these failures, [but] testing suggests a weak material set of die/package combination, system thermal management designs, and customer use patterns are contributing factors."

5 In *Hollinger,* we expressly "adopt[ed] the standard of recklessness articulated by the Seventh Circuit in *Sundstrand Corp.*" 914 F.2d at 1569.

6 It appears that the term "deliberate recklessness" was coined by the district court that we affirmed in *Silicon Graphics.* Our opinion in that case was the first time we ever used the term. The only other appellate court to have used the term previously did so less than one month before we did, and it cited to the district court's decision that we affirmed, *In re Silicon Graphics, Inc. Securities Litigation,* 970 F.Supp. 746 (N.D.Cal.1997). *See In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 530 (3d Cir.1999).

7 In their reply brief, Plaintiffs cite *In re Oracle Corp. Securities Litigation,* 627 F.3d 376, 390 (9th Cir.2010), and argue that the standard for deliberate recklessness does not include an element of intent or conscious misconduct. *Oracle,* however, concerned the scienter standard for summary judgment, and we had previously held that "[b]ecause the PSLRA did not alter the substantive requirements for scienter under § 10(b), [ ] the standard [for establishing scienter] on summary judgment or JMOL remains unaltered by *In Re Silicon Graphics.*" *Howard,* 228 F.3d at 1064. Unlike *Oracle* or *Howard,* this case comes to us following a motion to dismiss. We therefore apply the standard set forth in *In re Silicon Graphics.*

8 Item 303, 17 C.F.R. § 229.303(a)(3)(ii), requires registrants to:

> Describe 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. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

9 Citing *In re VeriFone,* we recently noted that failure to comply with Regulation S–K is insufficient for a claim under Rule 10b–5. *Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc.,* 759 F.3d 1051, 1061 n. 4 (9th Cir.2014).

10 Because Plaintiffs incorporate by reference Mr. Hunt's declaration, relying on portions of it in their complaint, we may properly consider the declaration in its entirety. *See Tellabs,* 551 U.S. at 322, 127 S.Ct. 2499; *see also City of Roseville Emps.' Ret. Sys. v. Sterling Fin. Corp.,* 963 F.Supp.2d 1092, 1107 (E.D.Wash.2013) ("Once a document is deemed incorporated by reference, the entire document is assumed to be true for purposes of a motion to dismiss, and both parties—and the Court—are free to refer to any of its contents.").

11 According to Hodge, HP's BIOS update "was released on or about on December 3, 2007."

12 Indeed, Hodge's timing of events is much more plausible than CW 1's. He explains that HP hypothesized in November 2007 "that repeated temperature mini-cycling could result in solder cracks ... and believed eliminating that temperature cycling would correct the issue." Accordingly, HP developed the BIOS updates to maintain a constant temperature within its computers. Nevertheless, as HP continued testing, it discovered that temperature cycling itself would not induce chip failures, but operating the NVIDIA chip within the specific problematic thermal profile would induce chip failures. Fortuitously, the BIOS update maintained NVIDIA's chips at a constant temperature outside of the problematic temperature range.

13 In *Makor,* the Seventh Circuit illustrated its point that

> it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.

513 F.3d at 710.

14 Plaintiffs do allege that Huang was heavily involved in the design of its chips. They support this allegation with the account of Confidential Witness No. 17 ("CW17"). Nevertheless, CW17 merely indicates that Huang "did not want an undue number of [solder] bumps" on the chips. This description of Huang's involvement does not indicate that he was heavily involved in the design of the flawed GPUs and MCPs or in the decision to use high-lead solder.

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939 F.Supp.2d 445
United States District Court,
S.D. New York.

PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM, individually and on behalf of all others similarly situated, Plaintiff,
v.
BANK OF AMERICA CORPORATION, et al., Defendants.

No. 11 Civ. 733(WHP).
|
April 17, 2013.
|
Order Denying Reconsideration June 12, 2013.

Synopsis
Background: Public school employees pension fund filed putative class action against bank and some of its current and past executives, alleging in an amended complaint after being granted leave to replead its claims, 874 F.Supp.2d 341, that the executives made misleading statements despite knowing that bank was vulnerable to repurchase claims, had a material weakness in its internal controls, and was failing to comply with generally accepted accounting principles (GAAP) and Securities and Exchange Commission (SEC) regulations. The bank executives moved to dismiss.

Holdings: The District Court, William H. Pauley III, J., held that:

plaintiff adequately pleaded strong inference that an executive acted with scienter in making statements bank's vulnerability to repurchase claims;

plaintiff failed to adequately plead strong inference that executives acted with scienter regarding the statements they made about repurchase claims;

plaintiff's claim based on SEC comment letter failed to plead sufficient facts to state a securities fraud claim; and

plaintiff alleged sufficient facts to show that executives knowingly made materially misleading statements by certifying that they were complying with GAAP and SEC reporting obligations.

Motion denied.

Attorneys and Law Firms

***447** Mark R. Rosen, Jeffrey A. Barrack, Barrack, Rodos & Bacine, Philadelphia, PA, A. Arnold Gershon, Barrack, Rodos & Bacine, New York, NY, David Avi Rosenfeld, Samuel Howard Rudman, Robbins Geller Rudman & Dowd LLP, Melville, NY, for Plaintiff.

Jay B. Kasner, Scott D. Musoff, Skadden, Arps, Slate, Meagher & Flom LLP, Patrick J. Smith, Jeffrey David Rotenberg, John Michael Hillebrecht, DLA Piper U.S. LLP, Samantha Noel Bent, Dewey & Leboeuf, Robert Jeffrey Jossen, Katherine Keely Rankin, Dechert, LLP, Lawrence Jay Portnoy, Brian Marc Burnovski, Charles S. Duggan, Davis Polk & Wardwell L.L.P., James J. Capra, Jr., King & Spalding LLP, Fraser Lee Hunter, Jr., Jacob David Zetlin–Jones, Wilmer, Cutler, Hale & Dorr, L.L.P., Michael G. Bongiorno, Wilmer Cutler Pickering Hale and Dorr LLP, New York, NY, Adam Jay Wasserman, Dechert LLP, Princeton, NJ, Jeffrey B. Rudman, Wilmer Cutler Pickering Hale and Dorr LLP, Boston, MA, for Defendants.

MEMORANDUM & ORDER

WILLIAM H. PAULEY III, District Judge.

Lead Plaintiff Pennsylvania Public School Employees' Retirement System ***448** ("Plaintiff") brings this putative class action against Bank of America Corporation ("BoA") and current and past officers and directors of BoA: Kenneth D. Lewis, Joseph Lee Price, II, Brian T. Moynihan, Neil Cotty, and Charles H. Noski (the "Executive Defendants"). The Executive Defendants move to dismiss the Amended Consolidated Class Action Complaint. For the following reasons, the Executive Defendants' motion is denied.

BACKGROUND

This Court's July 11, 2012 Memorandum & Order describes the allegations undergirding this action. *See*

Pa. Pub. Sch. Emps' Ret. Sys. v. Bank of Am. Corp., 874 F.Supp.2d 341, 346 (S.D.N.Y.2012). In that Memorandum & Order, this Court dismissed all defendants except BoA from this action, granted Plaintiff leave to re-plead its claims against the Executive Defendants, and denied the motion to dismiss with respect to the Section 10(b) and Rule 10b–5 claim against BoA. Plaintiff filed its Amended Complaint on August 13, 2012.

Originally, Plaintiff alleged two claims against the Executive Defendants: (1) violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b–5, and (2) violations of Section 20(a) of the Exchange Act. This Court dismissed Plaintiff's first claim because it failed to plead the required strong inference of scienter. *Pa. Pub. Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 359. This Court also dismissed Plaintiff's second claim for failing to plead the required culpable state of mind. *Pa. Pub. Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 368.

In its initial Complaint, Plaintiff alleged that the BoA Defendants: (1) tolerated robo-signing; (2) failed to disclose BoA's vulnerability to repurchase claims; (3) deliberately circumvented internal controls in establishing allowances for repurchase claims; (4) kept reserves for repurchase claims low to forestall additional repurchase claims; (5) fought repurchase claims to discourage investors from asserting additional ones; (6) resisted investor attempts to examine loan files; (7) concealed BoA's use of Mortgage Electronic Registration Systems, Inc. ("MERS"); and (8) failed to notify mortgage-backed securities ("MBS") purchasers of breaches. Plaintiff also alleged that the magnitude of the fraud created an additional basis for establishing scienter. This Court found those allegations insufficient and held that "Plaintiff does not allege that the Executive Defendants knew of specific contradictory information at the same time they made misleading statements." *Pa. Pub. Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 359.

In its Amended Complaint, Plaintiff alleges that the Executive Defendants made misleading statements despite knowing that (1) BoA was vulnerable to repurchase claims; (2) BoA had a material weakness in its internal controls; and (3) BoA was failing to comply with generally accepted accounting principles ("GAAP") and SEC regulations.

First, Plaintiff alleges that a letter dated May 13, 2010 from BoA's outside counsel to the Financial Crisis Inquiry Commission ("FCIC") establishes Moynihan's scienter. The letter "summarized the negative effects flowing from BoA's overemphasis on generating loans for securitization without due regard to prudent lending." *Pa. Pub. Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 364. It was sent in response to a request from FCIC Chairman Green, who asked Moynihan to expand on prior testimony that he had given to the FCIC. (Amended Consolidated Class Action Complaint, dated August 13, 2012 ("AC") ¶¶ 86, 301.) The letter contradicted Moynihan's subsequent representations regarding BoA's ***449** vulnerability to repurchase claims. (AC ¶ 302.)

Plaintiff also alleges, more generally, that the other Executive Defendants knew of repurchase liabilities and did not adequately disclose them. Previously, this Court found that the Executive Defendants had been "forthright in disclosing losses on repurchase claims." *Pa. Pub. Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 361. Plaintiff now alleges that even if the Executive Defendants disclosed certain repurchase *claims,* they failed to disclose repurchase *demands.* (AC ¶ 302). Repurchase claims refer to lawsuits or other formal proceedings seeking to compel repurchase; repurchase demands refer to pre-litigation letters requesting repurchase. Similarly, Plaintiff alleges that scienter can be inferred from the fact that BoA entered into tolling agreements with Government Sponsored Enterprises ("GSEs") regarding their repurchase demands. (AC ¶ 302(a).) Plaintiff alleges that BoA wrongfully delayed disclosure of these demands.

Second, Plaintiff alleges that the Executive Defendants were knowingly responsible for material weaknesses in BoA's internal controls. (AC ¶ 304.) Specifically, on January 29, 2010, the SEC sent a letter to BoA regarding BoA's policy of accounting for certain contingencies. The January letter asked BoA to disclose its public filing information regarding its repurchase reserve calculation. Cotty and Noski were directly involved in replying to the letter. On May 3, 2010, the SEC sent another comment letter advising BoA that any "future filing" would require further disclosures. (AC ¶ 304(c).)

Third, Plaintiff alleges that the Executive Defendants failed to disclose information required by GAAP and SEC regulations. Specifically, Plaintiff alleges that generally accepted accounting principles require disclosure of potential liabilities. The Executive Defendants were made aware of potential liabilities through their review of various demand letters and their role in subverting generally accepted accounting principles. (AC ¶¶ 121(e), (k), (1), (n), 303, 304.) By certifying that they were complying with reporting obligations, they knowingly made materially misleading statements.

DISCUSSION

I. *Legal Standard*

On a motion to dismiss, a court must accept the material facts alleged in the complaint as true and construe all reasonable inferences in plaintiff's favor. *See Grandon v. Merrill Lynch & Co.,* 147 F.3d 184, 188 (2d Cir.1998). Nonetheless, "factual allegations must be enough to raise a right of relief above the speculative level, on the assumption that all of the allegations in the complaint are true." *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 555, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007) (requiring plaintiff to plead "enough fact [s] to raise a reasonable expectation that discovery will reveal evidence of [his claim]"). "To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.' " *Ashcroft v. Iqbal,* 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009) (quoting *Twombly,* 550 U.S. at 570, 127 S.Ct. 1955). "The plausibility standard is not akin to a 'probability requirement,' but it asks for more than a sheer possibility that a defendant has acted unlawfully." *Iqbal,* 556 U.S. at 678, 129 S.Ct. 1937 (citation omitted). "A court ruling on such a motion may not properly dismiss a complaint that states a plausible version of the events merely because the court finds a different version more plausible." *Anderson News. LLC, et al. v. Am. Media Inc.,* 680 F.3d 162, 185 (2d Cir.2012). "A pleading that ***450** offers 'labels and conclusions' or 'a formulaic recitation of the elements of a cause of action will not do.' Nor does a complaint suffice if it tenders 'naked assertion[s]' devoid of 'further factual enhancement.' " *Iqbal,* 556 U.S. at 678, 129 S.Ct. 1937 (quoting *Twombly,* 550 U.S. at 557, 127 S.Ct. 1955).

A court's "consideration [on a motion to dismiss] is limited to facts stated on the face of the complaint, in documents appended to the complaint or incorporated in the complaint by reference, and to matters of which judicial notice may be taken." *Allen v. WestPoint–Pepperell, Inc.,* 945 F.2d 40, 44 (2d Cir.1991). A complaint alleging securities fraud must meet the heightened pleading standard of Rule 9(b), which requires a plaintiff to "state with particularity the circumstances constituting fraud." Fed.R.Civ.P. 9(b); *see also ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.,* 493 F.3d 87, 99 (2d Cir.2007).

II. *Section 10(b) and Rule 10b–5 Claims*

Plaintiff asserts that the Executive Defendants violated Section 10(b) of the Exchange Act and Rule 10b–5. To state a claim for relief under Section 10(b) and Rule 10b–5, Plaintiff must allege "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Pac. Inv. Mgmt. Co. v. Mayer Brown LLP,* 603 F.3d 144, 151 (2d Cir.2010). The parties dispute whether the Amended Complaint adequately alleges scienter.

The Private Securities Litigation Reform Act of 1995 ("PSLRA") requires that the plaintiff "plead with particularity facts giving rise to a *strong* inference that the defendant acted" with an "intent to deceive, manipulate, or defraud" or acted recklessly. *ECA, Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.,* 553 F.3d 187, 198 (2d Cir.2009) (internal quotations omitted) (emphasis in original). "Recklessness is defined as at the least, an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *ECA,* 553 F.3d at 198 (internal quotation marks and alternations omitted). "The inquiry ... is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 323, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007) (emphasis in original).

In assessing whether a plaintiff has stated a claim, "a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." *Tellabs,* 551 U.S. at 323, 127 S.Ct. 2499. "A complaint will survive ... only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs,* 551 U.S. at 324, 127 S.Ct. 2499. "[S]cienter can be established by alleging facts to show either (1) that defendants had the motive and opportunity to commit fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness." *ECA,* 553 F.3d at 198. "[T]he strength of the circumstantial allegations [of conscious misbehavior or recklessness] must be correspondingly greater if there is no motive." *ECA,* 553 F.3d at 198–99 (internal quotation marks omitted). Here, Plaintiff relies on the second prong. (Pl.'s Mem. in Opp'n to Mot. to Dismiss ("Opp'n") at 5.)

***451** A. *Repurchase Claims*

Addressing Moynihan first, Plaintiff now alleges that the May 13 letter establishes his scienter because Moynihan knew of the information in the letter but nevertheless went on to make statements contradicting the representations in the letter. (AC ¶ 86.) This Court previously rejected the argument that the letter established scienter for the Executive Defendants because there was "no allegation that the Executive Defendants saw the letter or knew of its contents." *Pa. Pub. Sch. Emps.' Ret. Sys.,* 874 F.Supp.2d at 359.

In the Amended Complaint, Plaintiff alleges that Moynihan knew of the letter because it constituted part of his sworn testimony to the FCIC. According to Plaintiff, the letter responded to a request from FCIC Chairman Green, which was addressed to Moynihan and asked him to expand on his testimony. While the letter was signed by BoA's outside counsel on behalf of BoA, Moynihan likely knew its contents because it purported to respond to the FCIC's demand for Moynihan to supplement his testimony.

BoA argues that, even if Moynihan knew of the letter, there is nothing in the letter that specifically contradicted any of his public statements. But this Court's finding that the letter "summarized the negative effects flowing from BoA's overemphasis on generating loans for securitization without due regard to prudent lending" closes the door on that argument at the pleading stage. *Pa. Pub. Sch. Emps.' Ret. Sys.,* 874 F.Supp.2d at 364. This Court relied on that fact to find that "Plaintiff's allegations concerning BoA's knowledge of repurchase claims also raises a strong inference of scienter on BoA's part." *Pa. Pub. Sch. Emps.' Ret. Sys.,* 874 F.Supp.2d at 363–64. The May 13 letter establishes that Moynihan had knowledge of the repurchase claims and renders his subsequent representations misleading. Accordingly, Plaintiff adequately pleads the required strong inference that Moynihan acted with scienter regarding the repurchase claims.

Turning to the other Executive Defendants, Plaintiff alleges that their knowledge of undisclosed repurchase demands render their subsequent certifications misleading. But immediate disclosure of repurchase demands is not required. *See Higginbotham v. Baxter Int'l Inc.,* 495 F.3d 753, 760–61 (7th Cir.2007) ("Prudent managers conduct inquiries rather than jump the gun with half-formed stories as soon as a problem comes to their attention."); *cf. also Reiss v. Pan Am. World Airways, Inc.,* 711 F.2d 11, 14 (2d Cir.1983) (holding that, in the context of corporate merger negotiations, "[d]isclosure may in fact be more misleading than secrecy" because such negotiations involve "complex bargaining between two (and often more) parties which may fail as well as succeed, or may succeed on terms which vary greatly from those under consideration at the suggested time of disclosure").

Here, the repurchase demands required investigation and not all demands were meritorious. Plaintiff alleges that, given the size of the demands and the nature of the claims, the Executive Defendants must have known that the repurchase demands constituted a major undisclosed liability. But nothing in the Amended Complaint suggests that the Executive Defendants honestly believed that the existing reserves were inadequate. The Amended Complaint does not allege that the Executive Defendants conducted a review of each demand and assessed its merit. And regardless, BoA disclosed unresolved repurchase requests in August 2010 to the tune of $11.1 billion. As such, Plaintiff's allegations regarding the Executive Defendants' response to repurchase claims do ***452** not plausibly create a strong inference of scienter.

Nor do Plaintiff's allegations regarding non-disclosure of tolling agreements. Tolling agreements are entered into for a variety of reasons, and nothing in the Amended Complaint suggests that the Executive Defendants knew that the claims underlying the tolling agreements were valid. And BoA disclosed GSE repurchase requests in August 2010. (Declaration of Scott D. Musoff, dated Jan. 11, 2012 ("Musoff Decl.") Ex. D: 10–Q, dated Aug. 6, 2010 ("Aug. 2010 10–Q") at 40.) Accordingly, Plaintiff's allegations establish Moynihan's scienter but fail to establish scienter against the other Executive Defendants regarding the statements they made about repurchase claims.

B. *Material Weakness in Internal Controls*

Plaintiff alleges that the Executive Defendants were knowingly responsible for undisclosed weaknesses in BoA's internal controls. (AC ¶ 302(e).) This Court previously found that BoA failed to disclose a material weakness in its internal controls but noted that "it does not make sense that the Executive Defendants would circumvent internal controls to manipulate allowance levels while being forthright in disclosing losses on repurchase claims," *Pa. Pub. Sch. Emps.' Ret. Sys.,* 874 F.Supp.2d at 361. Plaintiff attempts to remedy this deficiency by alleging that the Executive Defendants did not timely disclose BoA's losses on repurchase claims and did not disclose repurchase demands. (AC ¶¶ 302(e), 304(e).)

Specifically, Plaintiff argues that an SEC comment letter indicates that Cotty and Noski were knowingly responsible for the weakness in internal controls. (AC ¶ 304.) In that letter, the SEC inquired as to why BoA had recognized a $3 billion settlement with the GSEs all at once, rather than accounting for portions of the liability earlier. Plaintiff argues that this letter demonstrates that the Executive Defendants were aware that it was improper not to disclose contingent liabilities. But Plaintiff does not plead sufficient facts regarding the Executive Defendants' judgment regarding the merits of the repurchase demands. Because these demands were speculative, they do not form the basis of a claim for lack of internal controls. Plaintiff's additional allegations do not change this analysis. To the extent that the SEC letter is a criticism of accounting practice, "[a]llegations of accounting irregularities, standing alone, are insufficient to state a securities fraud claim. Only where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." *In re JP Morgan Chase Sec. Litig.,* No. 02 Civ. 1282(SHS), 2007 WL 950132, at *13 (S.D.N.Y. Mar. 29, 2007) (internal alterations omitted).

C. *GAAP and SEC Regulations*

Although the Executive Defendants' failure to disclose potential liability arising from repurchase demands is not misleading in its own right, it may nevertheless violate GAAP and SEC regulations. *See S.E.C. v. Steadman,* 967 F.2d 636, 645 (D.C.Cir.1992) (noting that "accounting rules d[o] not obligate appellants to attempt to quantify the contingent liability through rough guesses or speculation," but holding that [generally accepted accounting principles] require disclosure of "the general nature of the potential liability, as long as there [is] 'a reasonable possibility' that it [will] be realized."). Violating GAAP and SEC regulations may not amount to a material misrepresentation. But falsely certifying compliance with those same regulations certainly can. *See Steadman,* 967 F.2d at 645.

***453** The Amended Complaint alleges sufficient specific facts to demonstrate that the Executive Defendants were aware of the repurchase demands, even if they were not aware of the merits of each individual demand. And the GAAP precept of Accounting for Contingencies ("FAS 5") requires disclosure of probable losses, even when the losses are not estimable, as long as there is a "manifestation by a potential claimant of an awareness of a possible claim or assessment." FAS 5, ¶ 10. Under FAS 5, BoA was obligated to disclose the general nature of the potential liability that it faced. Its failure to do so constituted a violation of FAS 5. The Executive Defendants were made aware of these potential liabilities by various demand letters and by their role in camouflaging those demands. (AC ¶¶ 121(e), (k), (1), (n).) By certifying that they were complying with FAS 5 when they had failed to disclose such potential liabilities, they knowingly made materially misleading statements. Accordingly, Plaintiff's allegations regarding the Executive Defendants' violation of GAAP and SEC regulations give rise to a strong inference of scienter.

III. *Section 20(a) Claims*

Plaintiff asserts claims against the Executive Defendants for violations of Section 20(a) of the Exchange Act. To survive a motion to dismiss, plaintiff must allege: (1) "an underlying primary violation by the controlled person"; (2) "control over the controlled person"; and (3) "particularized facts as to the controlling person's culpable participation in the fraud perpetrated by the controlled person." *In re AOL Time Warner, Inc. Sec. & ERISA Litig.,* 381 F.Supp.2d 192, 233 (S.D.N.Y.2004); *see also In re Smith Barney Transfer Agent Litig.,* 884 F.Supp.2d 152, 166 (S.D.N.Y.2012).

"While the Second Circuit has not yet addressed the meaning of culpable participation at length, other than to state that a determination of § 20(a) liability requires an individualized determination of a defendant's particular culpability, courts have required a showing of both fraudulent conduct and a culpable state of mind." *In re Emex Corp. Sec. Litig.,* No. 01 Civ. 4886(SWK), 2002 WL 31093612, at *10 (S.D.N.Y. Sept. 18, 2002) (internal quotation marks omitted).

Originally, this Court dismissed Plaintiff's Section 20(a) claim for "failing to allege particularized facts of the Executive Defendants' culpable participation in the fraud perpetrated by the controlled person." *Pa. Pub. Sch. Emps.' Ret. Sys.,* 874 F.Supp.2d at 361 (internal quotations omitted). As explained above, Plaintiff's new allegations plausibly establish fraudulent conduct and a culpable state of mind as to all Executive Defendants for failing to comply with GAAP and SEC regulations and against Moynihan for failing to disclose repurchase liabilities. Accordingly, the Executive Defendants' motion to dismiss Plaintiff's Section 20(a) claim is denied.

CONCLUSION

For the foregoing reasons, the Executive Defendants' motion to dismiss the Amended Complaint is denied. The Clerk of the Court is directed to terminate the motion pending at ECF No. 173.

SO ORDERED.

MEMORANDUM & ORDER

Lead Plaintiff Pennsylvania Public School Employees' Retirement System ("Plaintiff") brings this putative class action against Bank of America Corporation ("BoA") and current and past officers and directors of BoA: Kenneth D. Lewis, Joseph Lee Price, II, Brian T. Moynihan, Neil Cotty, and Charles H. Noski (the "Executive Defendants"). By Memorandum & Order dated April 17, 2013, this ***454** Court denied the Executive Defendants' motion to dismiss. Moynihan moves for partial reconsideration of that Memorandum & Order.

BACKGROUND

This Court's July 2012 and April 2013 Memoranda & Orders set forth the allegations underlying this action. *See* 939 F.Supp.2d at 448; *Pa. Public Sch. Emps' Ret. Sys. v. Bank of Am. Corp.,* 874 F.Supp.2d 341, 346 (S.D.N.Y.2012).

DISCUSSION

I. *Reconsideration*
"A motion for reconsideration under Local Rule 6.3 will generally be denied unless the moving party can point to controlling decisions or data that the court overlooked—matters, in other words, that might reasonably be expected to alter the conclusion reached by the court." *Panchishak v. U.S. Dep't of Homeland Sec.,* No. 08 Civ. 6448(WHP), 2010 WL 4780775, at *1 (S.D.N.Y. Nov. 22, 2010) (internal quotation marks omitted) (quoting *Shrader v. CSX Transp., Inc.,* 70 F.3d 255, 257 (2d Cir.1995)), *aff'd,* 446 Fed.Appx. 361 (2d Cir.2011). "It is implicit in this language that a motion for *reconsideration* cannot assert new arguments or claims which were not before the court on the original motion and consequently cannot be said to have been *considered.*" *Koehler v. Bank of Bermuda Ltd.,* No. M18–302 (CSH), 2005 WL 1119371, at *1 (S.D.N.Y. May 10, 2005); *see also Panchishak,* 2010 WL 4780775, at *1. Reconsideration is not an invitation for parties to "treat the court's initial decision as the opening of a dialogue in which that party may then use such a motion to advance new theories or adduce new evidence in response to the court's rulings." *de los Santos v. Fingerson,* No. 97 Civ. 3972(MBM), 1998 WL 788781, at *1 (S.D.N.Y. Nov. 12, 1998). "The standard for reconsideration is strict and the decision is within the sound discretion of the district court." *Robbins v. H.H. Brown Shoe Co., Inc.,* No. 08 Civ. 6885(WHP), 2009 WL 2496024, at *1 (S.D.N.Y. July 22, 2009) (internal quotation marks omitted).

In its April 2013 Memorandum & Order, this Court considered three theories of securities fraud liability. Specifically, Plaintiff alleged that the Executive Defendants violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b–5 and Section 20(a) of the Exchange Act because they made misleading statements despite knowing that (1) BoA was vulnerable to repurchase claims; (2) BoA had a material weakness in its internal controls; and (3) BoA was failing to comply with generally accepted accounting principles ("GAAP") and SEC regulations. This Court found that Plaintiff's allegations regarding BoA's failure to comply with GAAP and SEC regulations plausibly stated claims against each Executive Defendant. It also found that Plaintiff's allegations regarding Moynihan's knowledge of repurchase claims plausibly stated a claim. Moynihan now moves for reconsideration of that latter finding.

This Court found that, among other things, a letter dated May 13, 2010 sent from BoA's outside counsel to the Financial Crisis Inquiry Commission ("FCIC") established Moynihan's scienter. According to Moynihan, this finding was improper because the Court did not take judicial notice of the contents of the letter and instead relied instead on Plaintiff's description in the Amended Complaint. In its July 2012 Memorandum & Order, this Court relied on the Original Complaint and made the following observations regarding the letter: "BoA informed the FCIC that in 2006 and 2007, Countrywide sold mortgage-backed securities with a total par value of $118 billion. The letter further noted that the par value of the interest ***455** held by BoA was only $2 billion as of February 2010. The letter also stated that 37% of Alt–A loans and 52% of Countrywide's subprime loans were delinquent." *Pa. Public Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 359. Relying on a host of allegations, this Court found that the Original Complaint raised a strong inference against BoA concerning its knowledge of repurchase claims. As an example, this Court found that the May 13 letter bolstered an inference of scienter because the letter's contents "summarized the negative effects flowing from BoA's overemphasis on generating loans for securitization without due regard to prudent lending." *Pa. Public Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 359.

A review of the May 13 letter confirms this Court's initial description. The letter asserts: "The par value at issuance of the securities sold by Countrywide was approximately $118 billion." (Declaration of Scott D. Musoff, dated Nov. 5, 2012, ("Musoff Decl.") Ex. A: Correspondence between BoA and the FCIC, dated May 13, 2010 ("May 13 letter") at 7.) It also notes that "[t]he value of [BoA's] retained interest in these securities was approximately $2 billion as of February 19, 2010," and states that "[f]or the legacy Countrywide Alt–A loan portfolio, as of December 31, 2009, approximately 37% were delinquent by thirty days or more[,] and ... [f]or the legacy Countrywide subprime first lien loan portfolio, as of December 31, 2009, approximately 52% of loans were delinquent by thirty days or more." Finally, it reports that the "value of the entities retained interest has substantially decreased since the issuance of those securities." (Musoff Decl. Ex. A at 7).

Far from being reasonably expected to alter this Court's conclusions, the May 13 letter corroborates Plaintiff's original complaint. Moynihan argues that this Court erred in concluding that the FCIC letter "summarized the negative effects flowing from BoA's overemphasis on generating loans for securitization without due regard to prudent lending." *Pa. Public Sch. Emps' Ret. Sys.,* 874 F.Supp.2d at 359. But the letter speaks for itself and supports no other conclusion.

Moynihan contends that the letter says nothing about exposure to repurchase claims and merely alerts readers to the decline in value in subprime mortgages. While the letter does not explicitly reference repurchase claims, it buttresses allegations that Moynihan was aware of the consequences of BoA's overemphasis on generating mortgage inventory. The letter reveals Moynihan's awareness of the sheer magnitude of the securitization of subprime mortgages and their subsequent precipitous decline in value. Knowledge of these facts, viewed in context with the other allegations in the Amended Complaint, make it more likely that Moynihan knew that BoA faced repurchase claims far larger than what it had disclosed to the public.

Unlike the atomized approach to scienter Moynihan urges this Court to adopt, no single allegation need conclusively establish scienter. While courts may address allegations in sequence, they must review them as a whole: "The inquiry ... is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Tellabs Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 323, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007) (emphasis in original). Taken collectively, the allegations against Moynihan plausibly state a strong inference that Moynihan acted with scienter regarding the repurchase claims.

***456** *CONCLUSION*

For the foregoing reasons, Moynihan's motion for partial reconsideration is denied. The Clerk of the Court is directed to terminate the motion pending at ECF No. 199.

SO ORDERED.

All Citations

939 F.Supp.2d 445, Fed. Sec. L. Rep. P 97,387, 297 Ed. Law Rep. 920