

Client Update

SEC Complaint Serves as Reminder to Carefully Consider Disclosure Obligations Relating to Government Investigations

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Registrants, particularly those involved in highly regulated industries, frequently must determine whether and when a government investigation and related pending or threatened litigation must be disclosed in its periodic reports filed with the Securities and Exchange Commission (“SEC”). On September 9, 2016, the SEC filed a complaint against a company and its general counsel that should serve as a reminder for any registrant subject to a government investigation to ensure that it has robust procedures in place to review disclosure requirements in connection with government investigations in light of the facts uncovered by any internal investigation and the course of settlement discussions with the government.

The SEC complaint alleges violations of the federal securities laws due to the company’s failure timely to disclose a loss contingency, or record an accrual for, a U.S. Department of Justice (“DOJ”) investigation into an alleged violation of the False Claims Act. In *SEC v. RPM International Inc. and Edward W. Moore*, filed in the District Court for the District of Columbia against RPM International Inc. (“RPM”) and its general counsel and chief compliance officer, Edward W. Moore, the SEC alleges that RPM and Moore violated the antifraud, books and records, and internal control provisions of the federal securities laws. The gravamen of the complaint is that, in light of its own review of the facts underlying the DOJ’s investigation and negotiations with the DOJ about a settlement, RPM knew that it faced, but failed to account for and disclose, a material loss that was probable and reasonably estimable and accordingly required both accrual and disclosure under the relevant accounting and financial reporting rules.

SEC COMPLAINT'S FACTUAL ASSERTIONS

One of RPM's wholly owned subsidiaries, Tremco, Inc. ("Tremco"), provided roofing materials and services under a contract with the federal government. In 2011, the DOJ began an investigation after a *qui tam* complaint was filed under the False Claims Act against RPM and Tremco. The *qui tam* complaint alleged that Tremco overcharged the government under certain contracts by, in part, failing to provide required price discounts.

RPM became aware of the DOJ investigation in March 2011 when Tremco received a subpoena from the government. Mr. Moore, as RPM's general counsel and chief compliance officer, was responsible for overseeing RPM's response to the DOJ investigation.

In September 2012, RPM's outside counsel met with the DOJ to discuss the investigation. During the meeting, RPM's counsel informed the DOJ that, based on an analysis by a consultant, Tremco had overcharged the government by at least \$11 million. In early October, RPM issued its earnings release and filed its 10-Q for the first quarter ended August 31, 2012. Neither the earnings release nor the 10-Q disclosed the existence of the DOJ investigation or reflected an accrual for the potential liability.

In December 2012, RPM and its outside counsel discussed a settlement offer that RPM planned to submit to the DOJ. The settlement offer totaled between \$27 and \$28 million, which reflected the amount RPM then believed it had overcharged the government. In early January 2013, RPM issued its earnings release and filed its 10-Q for the second quarter ended November 30, 2012 without any reference to the DOJ investigation. Less than a week later, RPM submitted a settlement proposal to the DOJ offering to settle the False Claims Act violation for \$28.3 million.

On March 29, 2013, the DOJ countered RPM's settlement offer with \$71 million. Six days later, RPM issued its earnings release and filed its 10-Q for the third quarter ended February 28, 2013, which for the first time disclosed the existence of the DOJ investigation and recorded an accrual of \$68.8 million for the potential liability with respect to the violation of the False Claims Act.

RPM's annual report on Form 10-K for the year ended May 31, 2014, filed in July 2013, discussed the DOJ investigation and the related accrual that RPM had recorded in the third quarter. However, the 10-K indicated that the disclosure of the investigation and the recording of the accrual had been made in a timely

manner and failed to disclose any material weakness in RPM's internal control over financial reporting at any point during the prior fiscal year.

On August 28, 2013, the DOJ announced its settlement with RPM for \$61 million.

The SEC complaint alleges that, in light of the DOJ's investigation and RPM's own review of the facts, RPM faced a material loss that was, at the time RPM issued its earnings release and filed its quarterly reports for the quarters ended August 31, 2012, November 30, 2012 and February 28, 2013, probable and reasonably estimable, which triggered a requirement that RPM disclose the loss contingency and record an accrual on its books. The SEC complaint further alleges that RPM's 10-K was misleading because the disclosure of the DOJ investigation and the recording of the related accruals were not in fact timely and there had been a material weakness in internal control over financial reporting throughout the year.

In addition to RPM, the SEC names Moore as a defendant. The SEC complaint asserts that Moore oversaw RPM's response to the DOJ investigation, but failed to disclose material facts about the investigation to fellow RPM officers, the audit committee, and the independent auditors. Specifically, Moore allegedly knew—but failed to timely inform RPM officers, the audit committee, and the independent auditors—that RPM was in settlement discussions with the DOJ or that RPM determined that Tremco had overcharged the government between \$27-28 million. The complaint also asserts that Moore made material misrepresentations to the independent auditors about the investigation, including falsely telling the independent auditors that no claims had been asserted, even though the DOJ had sent him a copy of the *qui tam* complaint. According to the SEC's complaint, these misrepresentations caused RPM to submit materially false and misleading filings to the SEC from October 2012 to December 2013.

IMPLICATIONS

The SEC takes the position that by acknowledging to the DOJ in September and October 2012 that Tremco had overcharged the government by at least \$11.4 million, RPM was required under Accounting Standards Codification 450 ("ASC 450") to disclose the loss contingency and to record an accrual of at least that amount. Furthermore, because that amount was material to RPM's first quarter net income, the MD&A included in the 10-Q for the first quarter ended August 31, 2012 should have disclosed the existence of the investigation and that it would have a materially unfavorable impact on RPM's net income.

By the time of the filing of RPM's next 10-Q, the company's internal analysis of the overcharges to the government reached between \$27 and \$28 million and it was planning to submit a settlement proposal for that amount. Although this analysis and proposed settlement had not been shared yet with the government at the time RPM filed its second quarter 10-Q, the SEC complaint charges that the failure to record an accrual of at least this amount was a further violation of ASC 450 and the failure to disclose the impact of the investigation in the MD&A was a violation of applicable disclosure requirements.

The obligation to disclose a government investigation and to record an accrual is a highly fact specific analysis. As in this case, the facts uncovered by any internal investigation and the discussions and settlement negotiations with the government can be some of the most critical pieces of the determination.

CONCLUSION

The SEC's complaint against RPM serves as a reminder about the importance of transparency in the process around evaluating disclosures, particularly around areas of judgment such as accrual decisions. It also underscores the importance for internal transparency among general counsel, c-suite employees, and the audit committee when dealing with situations as dynamic and unpredictable as government investigations and settlement negotiations. Companies should keep in mind that decisions around recording accruals and disclosures of loss contingencies should be made in consultation with independent auditors as well as, in many cases, outside counsel. Finally, the RPM case is a reminder to those individuals—such as attorneys and compliance officers—who sit in “gatekeeper” roles at companies that the SEC will carefully scrutinize their conduct.

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Please do not hesitate to contact us with any questions.