Articles + Publications | October 12, 2022

SEC Digs in on Loss Contingency Disclosure Requirements

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On September 22, the U.S. Securities and Exchange Commission (SEC) filed charges against three former executives of a technology acquisition company (the Company) for making false and misleading statements to auditors, and failing to include required information in its financial statements — both relating to an ongoing SEC investigation into one of the Company's investments.

Between January and May 2018, defendants — the former CEO, the former CFO, and a former director of the Company — allegedly violated federal securities laws when they made false and misleading statements to outside auditors about an ongoing SEC investigation into the Company's investment in a biotechnology company (the Biotech Investment). Despite knowing of the investigation and the SEC's intention to recommend charging the Company with violating federal securities laws, the defendants told the auditors that they were not aware of "any situations where the company may not be in compliance with any federal or state laws or government or other regulatory body regulations." The veracity of this assertion was rendered false once it was discovered that, between March 2015 and November 2018, the SEC's Division of Enforcement sent multiple subpoenas to the Company, its officers, and directors, requesting documents and seeking testimony related to the SEC's investigation into the Biotech Investment. Moreover, in April 2017, the SEC's Division of Enforcement sent a Wells notice to the Company notifying it of the SEC staff's intention to recommend charges.

Separately, the former CEO and CFO were alleged to have violated the anti-fraud provisions of the federal securities laws and to have aided and abetted the Company's reporting violations when they signed the Company's 2017 Form 10-K and 2018 first quarter Form 10-Q, neither of which disclosed the potential SEC enforcement action — thereby failing to disclose a loss contingency as required by generally accepted accounting principles (GAAP). This conduct was violative because a loss contingency related to the existence and status of the SEC's investigation into the Biotech Investment was required to be disclosed as there was a reasonable possibility that it could lead to a material loss for the Company. Indicative of this risk, were the facts that: (1) the SEC staff intended to recommend that the SEC charge the Company with violating Section 7(a) of the Investment Company Act and seek a civil penalty; (2) settlement discussions with the SEC's staff had broken down; (3) any penalty paid by the Company would be material; and (4) the Company knew that the SEC's enforcement action was likely coming, and coming soon. Significantly, the Company even acknowledged internally that the loss contingency would have been material to investors because if it was recorded, it could have "killed the Company given its poor financial condition." Of particular note, as highlighted in the SEC complaint, in a March 5, 2018 text message string including the former CEO and CFO, one party to the string wrote "with the SEC complaint only days/weeks away from being served … we really need to get this 10-K filed ASAP."

According to the SEC, the defendants' persistent and purposeful failure to disclose the existence and status of the SEC investigation constituted a violation of generally accepted accounting principles and further led the SEC to determine that they had breached Rule 13b2-2 of the Securities Exchange Act of 1934. Additionally, the SEC charged Thompson and Loveless with violating the antifraud provisions of Section 17(a)(2) and (3) of the Securities Act of 1933, and aiding and abetting the Company's violations of the reporting provisions of Exchange Act Section 13(a) and Rules 12b-20, 13a-1, and 13a-13 thereunder. The defendants ultimately consented to the entry of a final judgment against them requiring the former CEO, CFO, and director to pay civil penalties of $50,000, $75,000, and $10,000, respectively; and barring the former CEO and CFO from acting as an officer or director of any public company for three years.

Takeaway

Situations like the above are not isolated events. In today's ecosystem, companies are more likely than ever to be faced with the potential for investigation or other enforcement action by any number of regulatory bodies — whether it be the SEC, FINRA, NASDAQ, DOJ, FTC, OSHA, and so on. In the face of such investigations or enforcement actions, companies often struggle with assessing when events have escalated such that they are subject to disclosure requirements. This assessment can be difficult, therefore it is crucial that companies undertake a diligent review and engage appropriate assistance to ensure the accuracy and rigor of that review. Indeed, as noted by the SEC in its order, "…[the Company and its officers] never conducted a good faith assessment as to whether the possible pending enforcement action needed to be disclosed. Instead, the Company and its officers did the opposite — they mislead [the Company's] auditors and failed to disclose the existence and status of the SEC's [] investigation." Casting a blind eye will not aid in the avoidance scrutiny, but rather will heighten the degree of attention focused on each and every deficiency.

Members of the Troutman Pepper team are available to assist with the internal assessment of disclosure obligations and can further assist on any and all SEC developments.

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