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The Next Wave Of Securities Litigation: FIN 48

Law360, New York (November 18, 2008) -- Two of every businessperson's least favorite issues – class action securities litigation and taxes – may combine in the near future to create the “next wave” of litigation exposure.

The current wave of litigation involving the subprime meltdown has been difficult for many financial service companies, but it involves only a somewhat narrow (albeit important) spectrum of companies.

Part of what is happening with the subprime situation is that companies are being required to “mark to market” securities for which there is now only a thin or nonexistent market, leading to unexpected and previously undisclosed liabilities.

Another area where previously undisclosed (or under-disclosed) liabilities are being exposed, and which may create exposure for a broader spectrum of companies, comes from recently adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (“FIN48”), which requires companies to quantify and give much greater visibility to their income tax exposure from all jurisdictions (i.e., federal, state, local, and foreign).

FIN 48 essentially requires companies to provide a snapshot of their risk exposure to the potential challenge of their prior income tax positions by tax authorities.

In its May 18, 2007 report, “Peeking Behind the Tax Curtain”, Credit Suisse analyzed 361 companies in the S&P 500 and found a total of \$141 billion in unrecognized tax benefits identified pursuant to FIN 48, which represents future liabilities should those tax positions be overruled.

Particular industries are affected more than others. Pharmaceutical, financial services and telecommunication companies led the way in terms of their gross amount of future risk, and internet companies had the highest percentage of exposure as a percentage of their total liabilities (nearly 20 percent).

This very public risk exposure gives class action plaintiffs a new avenue to pursue against public companies under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. A number of potential catalysts highlight this risk.

First, similar to what occurred in stock option backdating, academic attention has come to this subject, including the past use of tax reserves to “smooth” earnings.

Second, Congress has taken an active interest. In August 2007, Senator Carl Levin, D-Mich., the head of the Senate’s Permanent Subcommittee on Investigations (“PSI”), sent letters to companies requesting information related to their exposure under FIN 48 – specifically focusing on foreign entities or foreign jurisdictions.

Many observers believe this is a prelude to a planned assault on abusive tax shelters and potential tax evasion by corporations. Finally, tax is in the news and in the courts. Past tax positions are coming back to haunt some companies.

Also, tax-based assets on balance sheets have been reviewed and come into question. Currently pending in the Southern District of New York is a securities class action case against Scottish Re Insurance based upon how that company accounted for its deferred tax assets. (In re Scottish Re Group Sec. Litig. (SDNY 06 Civ 5853).

FIN 48 became effective in 2007 for most calendar year companies. It governs how companies must account for and report income tax contingencies (“unrecognized tax benefits” (“UTBs”) in the language of FIN 48) and includes certain other tax positions accounted for in accordance with FASB Statement No. 109, Accounting for Income Taxes, such as: deductions taken or expected to be taken; taxable income excluded or recharacterized; conclusions whether to file a tax return or not; and conclusions made as to the tax status of a transaction. FIN 48 represents a dramatic change from how companies previously recorded and reported such contingencies.

FIN 48 replaces FASB Statement No. 5, Accounting for Contingencies (“FAS 5”), with regard to the recording and disclosure of income tax contingencies. Under FAS 5, a loss contingency was not recognized unless the liability was deemed “probable” and the amount of the loss could be “reasonably” estimated.

Frequently, companies took the position that they could not calculate a reasonable estimate for a given contingency and accordingly did not establish a loss reserve. In the “FAS 5 world” there was diversity in practice regarding the derecognition and measurement of tax positions in the financial statements.

Companies recorded tax contingencies before under FAS 5, but they were frequently included in “other accrued liabilities” and were difficult to quantify and understand from company to company due to the minimalist or even boilerplate disclosures many entities used.

Under FIN 48, however, uncertainty regarding income taxes is subject to a different set of rules that potentially opens companies to second guessing and the possibility of future securities class actions.

In addition, there is a “cards on the table” aspect of FIN 48 that itself changes the dynamic: by publicly identifying areas of uncertainty, the IRS and other regulators such as the Securities and Exchange Commission (“SEC”) may be inclined to probe further, making an adverse outcome more likely.

As reported in *The Tax Advisor*, IRS official Robert Adams, speaking at a July 2007 Tax Council Policy Institute Panel, said “Taxpayer disclosures are the centerpiece for revenue agent training in 2007 and that IRS agents are being trained to look at comment letters issued to taxpayers by the SEC.”

FIN 48 uses a two-step model to determine the amount of an uncertain tax benefit. A company recognizes a tax benefit when it is “more likely than not” that its tax positions will be sustained (based solely on its merits and absent the consideration of any examination risk) if challenged and considered by the highest court of the relevant jurisdiction.

When these factors are ascertainable, the company would measure the tax benefit based upon the largest amount of tax benefit that is cumulatively more than 50 percent likely.

Obviously, public disclosure of the “amount recognizable” also provides the basis for calculating the amount that is thought to be not recognizable. The amount thought to be unrecognizable is then recorded in a line item on the balance sheet identified as a “Liability for unrecognized tax benefits,” which could be a red flag for both the IRS and the plaintiff class action lawyers.

In securities class action cases, plaintiffs may describe this balance as the amount the defendants “knew” would be disallowed by the IRS. Thus, while FIN 48 technically describes how a tax “benefit” must be recognized, it also implies a quantification of a potential tax liability.

This accounting interpretation, with its expanded disclosure requirements, presents a significant informational advantage for the IRS (and other taxing authorities and jurisdictions). Armed with a company’s assessment that it only has a certain probability of success, it seems inevitable that the taxing authority will use that information to drive a harder bargain in settlement talks.

The SEC’s Chief Economist, Chester Spatt, in his March 8, 2007 speech “The Economics of FIN 48, Accounting for Uncertainty in Income Taxes”, expressly recognized this when he said that “more information about the taxpayer’s position ... may provide a ‘roadmap’ for the tax authority that undercuts the firm’s bargaining power.”

The assumption upon which a FIN 48 “benefit” is supposed to be calculated is that the relevant taxing authority has all the relevant information and is using it correctly. But in the real world, critical information is often not requested or reviewed by the adverse party, or its importance can be missed.

FIN 48 requires the taxpayer to assume that the IRS will be as smart and efficient as the outside counsel the taxpayer has hired to defend it from the IRS. The issuer’s evaluation is supposed to be based upon the technical merits of a tax position, taking into account administrative practices and precedents of the taxing authority that are widely understood.

But administrative practices and precedent can sometimes be at odds with the literal language of the tax statutes and regulations. Thus, judgments are inevitable, as will be second guessing and securities litigation when those judgments turn out to be wrong.

As to the mechanics of FIN 48 itself, it provides that the allowable tax benefit is the largest amount that is more than 50 percent likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

For example, assume a \$100 million amount is in dispute where one estimates a 15 percent chance of total victory (\$100 million), a 25% chance of settlement at \$80 million, and a 15 percent chance of a \$60 million settlement. Adding up the percentages, the company has concluded that it is at least 55 percent likely that it will settle for an amount not less than \$60 million.

Thus \$60 million is the only amount it may recognize, despite the fact that the assessment of an \$80 million settlement was individually viewed as more probable than the \$60 million settlement.

Take it a step further and assume that the company calculates that the probability of settling at \$10 million in the example above is 45 percent, which is obviously the highest individual probability outcome. Regardless, under FIN 48 the only amount recognizable is \$60 million.

What happens if the 45% probability comes to pass and the IRS or the relevant court determines the tax benefit is only \$10 million? Well, therein lies the potential for securities class action litigation.

In the scenario described, the company has done the only thing the accounting guidance would have it do -- yet it is easy to see how a jury could fail to understand that selecting the \$10 million benefit was not the most appropriate choice.

With the benefit of hindsight, plaintiffs may argue that management prepared the probability assessment data with “knowingly” false assumptions.

Given that the real world is always more complex than these illustrations suggest, it should be obvious that opportunities for potential abuse abound.

Often general counsel are not deeply involved in their tax department's assessments of tax positions and related documentation. The potential securities law consequences arising from FIN 48 exposure suggest that general counsel should pay close attention to how those probabilities are calculated and documented.

Many cases in securities litigation involve a product that failed to come out on time or failed to succeed in the marketplace, and where the so-called "smoking gun" is a pessimistic email from someone who opined along the lines that "this will never work."

The analogous problem might well arise in connection with the tax department's analysis and application of FIN 48, especially since industry practitioners indicated that many corporate tax departments were resource constrained and as a result many entities outsourced some of their FIN 48 analysis and application to third parties.

Industry practitioners also indicated potential exposures in the application of FIN 48 may arise due to the potentially incomplete understanding of the foreign tax positions taken by foreign subsidiaries in large multinational entities.

Very few individuals in a typical multi-national corporation would be expected to be well-versed in the details of foreign national and foreign local tax laws sufficient to form judgments on tax positions in accordance with FIN 48, and as a result, relying on foreign tax practitioners may present an inherent risk in adopting FIN 48.

One can also expect that mistakes in judgment may be challenged as violations of Sections 302 and 404 of Sarbanes-Oxley ("SOX"). While there is currently a split of authority, a minority of courts accept the premise that a purported violation of SOX provides an adequate basis for an alleged violation of Section 10(b).

In those jurisdictions, a "violation" or "error" in a company's FIN 48 calculation may provide the necessary predicate for a Section 10(b) and Rule 10b-5 violation.

Adding to FIN 48's litigation risk profile are the requirements that a company provide a table of the beginning and ending aggregate unrecognized tax benefits, and also specific disclosures about uncertain tax positions for which it is "reasonably possible" that the amount will significantly increase or decrease within the next 12 months – which includes management's estimate of the range of the possible increase or decrease, and a description of the open years by tax jurisdiction.

These disclosures would provide a handy scorecard for second guessing the good faith of management's judgment, and a potential road map to a taxing jurisdiction to address an entity's uncertain tax benefits in periods where the statute of limitations may be quickly approaching.

It also limits the opportunities for “earnings management” as changes in tax reserve positions will need to be supported with a quantifiable methodology and the articulated rationale for adjustments will need to be much more transparent.

Moreover, the requirements that a company disclose the nature of the event that could cause a change to UTBs, as well as the range of reasonably probable change, will invite IRS scrutiny on the front end, and SEC and private plaintiff scrutiny on the back end if undisclosed events result in a material change.

Early signs in SEC comment letters indicate that the SEC is focusing heavily on the completeness of the amounts provided in the table of UTBs disclosed in an entity’s financial statements, and the SEC is requiring companies to comply closely with the disclosure provisions of FIN 48.

As for the FASB, is FIN 48 merely the leading edge of a set of future requirements? In June, the FASB issued an exposure draft that would amend FAS 5 to provide for expanded disclosures for loss contingencies, unless certain criteria are met.

The current discussions regarding the adoption of a more principle-based (versus rule-based) accounting system should also be considered.

The bottom line is that the inevitable subjective judgments that are inherent in business are increasingly subject to more fulsome disclosure than ever before, and general counsels should redouble their attention to documentation and support in light of these new rules compelling transparency.

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