



Fair Value Accounting & Litigation: The Next Wave of Valuation Risk

By Antonio Yanez Jr.

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Fair Value Accounting & Litigation: The Next Wave of Valuation Risk

By Antonio Yanez Jr.

Some blame fair value accounting requirements for aggravating the economic downturn by requiring write-downs that exaggerate asset value declines. Others say that fair value accounting is the best method of recording asset values and that to blunt the effects of fair value accounting requirements would simply prolong the problem.

There is much to recommend fair value accounting. But, whatever the merits of the various positions, fair value accounting is having a significant impact in a number of areas, among them accounting-related litigation and securities class actions in particular. While the impact probably cannot be fully appreciated at this point, a number of implications for litigation are beginning to stand out:

Issued in late 2006, the "Statement of Financial Accounting Standards No. 157" or "FAS 157" took effect for fiscal years beginning after November 15, 2007 and interim periods within those years (though earlier application was encouraged).

In general terms, FAS 157 defines "fair value" and establishes a framework for measuring fair value. The definition is that "[f]air value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The framework involves, among other things, reference to a "fair value hierarchy" of inputs considered in valuation. First are "Level 1 inputs," or "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date." Second are "Level 2 inputs," which are inputs "other than quoted prices included within Level 1 that are observable for the asset or liability" for example, quoted prices for comparable assets. Third are "Level 3

inputs," which are "unobservable" and to be "developed based on the best information available in the circumstances," for example, where there is no active market for an asset. FAS 157 prioritizes inputs ranked higher in the hierarchy (Level 1) over those ranked lower in the hierarchy (Level 3).

With that context, three key implications for litigation of fair value accounting stand out:

1. Fair value accounting appears to be contributing to an increase in accounting-related litigation and securities class actions in particular. Before 2007, a downward trend in securities class action filings appeared to be emerging. Different explanations were offered for the trend. Some said that the Sarbanes-Oxley reforms had wrung manipulation out of the system. Others focused on improvements by the accounting profession. But perhaps the most commonly cited factor was the relative absence of stock price volatility.

Fair value accounting can be expected to increase stock price volatility which, in turn, will likely lead to more litigation. Quarter after quarter, investors get information about changes in the value of certain assets, and they will react to those changes. Stock prices will go down if asset values decrease. And, there will be investors who assert that the stock price dropped because the market was earlier misinformed. More than that, investors will have an economic incentive to make that assertion in litigation because the size of a stock price drop is a factor in the damages that potentially can be collected.

Indeed, an increase in litigation is already apparent. In 2008, 210 securities class actions were filed compared to 176 in 2007, according to *Securities Class Action Filings—2008: A Year in Review*, an annual report prepared by the Stanford Law School Securities Class Action Clearinghouse in cooperation with Cornerstone Research. A significant number of these cases were brought against financial institutions, almost all featuring fair value-related allegations.

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None of this is to suggest that the benefits intended to be achieved through fair value accounting are outweighed by the costs of increased litigation. Proponents point out that fair value accounting provides the most transparent information—which is of immeasurable value to investors, counterparties, potential merger partners, and others. Nor does an increase in securities litigation necessarily mean that the defendants in those cases (financial statement preparers, auditors, and others) are more likely to lose. However, an increase in litigation is likely and, in fact, already appears to have begun.

2. Fair value accounting litigation will focus on judgment. The judgment of financial statement preparers and auditors will likely be a focus in fair value litigation. There may not be much judgment involved in selecting a Level 1 input. A market price for an identical asset is what it is. But there is judgment in valuations involving Level 2 and Level 3 inputs. For example, there is judgment in determining whether assets are sufficiently analogous to permit Level 2-type comparisons and in selecting and using Level 3 inputs.

Those judgments are being second-guessed aggressively in litigation, and likely will be in the future. The types of allegations being made—and which can be expected to resonate—include claims that valuation models failed to appropriately consider factors reflecting deterioration in asset values, and that write-downs should have been made earlier than they were (both matters of judgment). There are allegations suggesting a failure to properly expose to whatever it was that was written down—put differently, that judgments about the content of disclosure were improper. There are allegations that warnings about write-downs should have been issued before the write-downs themselves were taken (also a matter of judgment). And there are allegations suggesting a failure to maintain systems that would have limited exposure in the first place to what was written down (again, a judgment call).

Recent U.S. Supreme Court precedent also ensures that this focus on judgment will begin from the early stages of securities litigation. In 2007, the Supreme Court issued a landmark decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, which held that before a securities case can get to discovery a court must weigh the allegations in the complaint and de-

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cide whether they suggest fraud or the absence of fraud. Where the suggestion of fraud is at least as strong as the absence of fraud, the case goes forward; otherwise, it does not. What that means in fair value lawsuits is that courts will have to concentrate right from the outset on the allegations about the accounting judgments—that is, the selection of inputs, the decisions about disclosure, the design of internal systems, and everything else—and decide whether they appear to be tainted by fraud or were made in good faith. And the focus on judgment will continue throughout the lawsuit.

This focus on judgment, too, is not necessarily a negative development even for the defendants. Pointing to good judgment exercised in good faith can be very effective with juries. But judgments are going to be questioned.

3. Fair value accounting brings to a head a conflict between the evolution of financial reporting on the one hand, and our system of litigation on the other. Fair value accounting is one aspect of an evolution in financial reporting that seeks to give users of financial statements more timely and more useful information even though that information may be more judgment-driven. For

example, measuring value based on historical cost would involve significantly less judgment but also could be significantly less useful. At the same time, our system of litigation permits those judgments to be second-guessed. And while more litigation and an increased focus on judgment is not necessarily a negative development for financial statement preparers, the fact remains that the process of litigating is expensive and disruptive even if one prevails at the end of the day.

So, there is the conflict. On the one hand, there is an evolution in financial reporting intended to benefit the users of financial information. On the other, given our system of litigation, that evolution will likely subject those that prepare financial statements to the expense and disruption of increased litigation. And the question is whether anything is going to be done about that. There have obviously been calls for reform for some time, but fair value accounting brings the need for reform into focus like never before.

About the author: Antonio Yanez Jr. is a litigation partner with Willkie Farr & Gallagher LLP and a member of the law firm's Securities Litigation & Enforcement practice group.

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