Hunting for Goodwill: Legal Liability for Failure to Test Intra-Annually

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The SEC requires that all reporting companies test for goodwill impairment once a year. Events may cause a reporting company's goodwill to become impaired during the course of a fiscal year. This article will examine the relationship of GAAP standards governing goodwill impairment and SEC regulations mandating that GAAP standards be followed and analyze a recent decision addressing section 10(b) and rule 10-b5 liability arising from the failure to test goodwill intra-annually.

INTRODUCTION

Whenever my son got a cut or scrape, he immediately called for a Band-Aid. When daughter sneezed she asked for a Kleenex. What they really wanted is an adhesive bandage or a tissue. These brand names, usually trademarked, have inherent value considered part of a company's goodwill. One court has defined goodwill as "the positive reputation a business may enjoy in the eyes of the public that creates a probability that old customers will continue their patronage."

In a corporate acquisition a company's goodwill equals the purchase price, net the expenses, less the fair value of net assets. In other words, it is the intangible value of the business above and beyond its bricks, mortar and equipment. However, in a corporate non-acquisition setting, goodwill may be more difficult to value. Bankruptcy Courts often focus on the value of a company's goodwill, perhaps the most valued asset left.

A company's goodwill could be impaired by an external disaster or a change in customer preferences. Historically, television networks, together with owned and operated stations and affiliates, competed with other television networks. But then came cable, satellite, DVDs, instant streaming and a variety of new forms of competition chasing after the finite pool of advertisers dollars. According to the Nielsen ratings for the week of August 20, 2012, NBC captured the largest audiences of over nine million viewers while cable channels TNT and ESPN each captured over five million viewers. This type of change in industry can be so fundamental and permanent as to result in an impairment to a company's goodwill.

The SEC requires that all reported companies test for goodwill impairment once a year and report it in their 10-K filings. However, events, such as a sudden change in the industry, may cause a reporting company's goodwill to become impaired during the fiscal year, i.e. intra-annually. SFAS 142 requires an intra-annual test for goodwill impairment when events cause a change in circumstances which make it more likely that the book value of a reporting unit exceeds its fair value.

An investor's window into the financial well being of a company is its 10-K and 10-Q statements filed with the SEC. If the valuation of goodwill is materially false, a purchaser of securities has a claim for recompense on the theory that the purchase price was inflated and the price dropped when the truth became known, thereby causing a loss to the stockholder.

This article will examine the relationship of GAAP standards with SEC regulations and a recent decision addressing a section 10(b) and rule 10-b5 (*17 C.F.R, § 240.10b–5)* action alleging shareholder injury from the failure to test goodwill intra-annually.

The Plaintiffs' Theory: *Res Ipsa*?

In *City of Omaha, Nebraska Civilian Employee's Retirement System v. CBS Corporation,* the plaintiffs were shareholders of CBS common stock who purchased the shares between April 28, 2008 and October 10, 2008. On October 10, 2008, CBS's announced a write down of $10 billion to goodwill. Shareholders alleged violations of section 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5 due to the Company's inflated value of goodwill reported on their 10K filing during the first quarter 2008. In essence, they alleged that if the defendant knew the goodwill was impaired by $10 billion on October 10, they knew or should have known it sooner.

In more precise terms, plaintiffs alleged that "CBS knowingly and/or recklessly issued false and misleading financial statements during the Class Period that were not prepared in accordance with GAAP and thus, as a matter of law, violated the Exchange Act by committing securities fraud." Plaintiffs claim defendants "repeatedly and misleadingly highlighted the 'strong' and 'pristine' nature of CBS's balance sheet throughout the Class Period, despite strong downward sales trends." Therefore CBS was materially overstating its income, goodwill and intangible assets.

CBS' 10-Q statement for the first quarter of 2008 reflected a book value far exceeding the market capitalization, which in the plaintiff's view was a red flag that goodwill had been impaired. Due to this gap, plaintiffs claimed that the Company should have followed the SFAS 142 28 guidelines and conducted an intra-annual impairment test of goodwill. They claimed that if the test had been performed in early 2008, the Company's goodwill would have been devalued thereby avoiding a write down in October 2008 causing the stock to plummet 20% in one day. Instead the stock price was artificially inflated and based on the SEC filings mislead purchasers such as the plaintiffs into purchasing the stock.

SEC regulations state that 10K and 10Q reports that are not prepared in accordance with FASB are presumed to be misleading or inaccurate. (SEC Regulation S–X, 17 C.F.R. § 210.4–01(a)(1) The plaintiff alleged that CBS 10Q for the first quarter were not in accordance with FASB standards in that CBS failed to conduct an intra-annual test for goodwill impairment as required and therefore the value of goodwill was materially misleading.

The chart (Table 1) provides the numbers the plaintiff relies on for the theory that the difference between stockholder's equity and market capitalization was ignored by CBS and therefore the basis for the fraud claim.

CBS attributed the decline in market capitalization in the first quarter of 2008 to the lower than expected advertising for Super Bowl XLII and the NCAA Men's Basketball Tournament, as well as the impact of television and radio station divestitures. Similarly its second quarter 10-Q filing reported the negated impact of the June 30, 2008 acquisition of CNET.

On October 10, 2008, CBS announced it had undergone impairment testing due to continued economic slowdown and decline in advertising spending. In Form 10-Q filed on November 4, 2008, CBS reported a non-cash impairment charge to goodwill of $10.99 billion.

The charge represented 48% decrease in goodwill of the Company. As a result of the disclosure of the write down CBS stock price dropped from $10.14 to $8.10. Plaintiffs contended that CBS was aware of the decline in goodwill in early 2008 due to the decreased price in market capitalization and this should have triggered and intra-annual impairment test. The legal theory of *res ipsa loquitor* ("the thing speaks for itself") comes to mind.

Plaintiffs allege that the defendants, including CBS and several of its directors, recklessly disregarded the standards set forth in SFAS 142, which requires interim testing where book value radically exceeds market value. The claim is that the defendants were motivated not to perform the impairment test so as to prevent the trigger of a debt CBS owed.

TABLE 1
10K FILING FOR 2007, 2008 AND 10Q FILING 2008

Time Period	*Shareholder's Equity*	*Market Capitalization*	*Goodwill*
2007 10K Filed on 2/28/08 Year ending 12/31/07	21.47	18.67	18.45
1st Quarter '08 10Q Filed on 5/2/08 Quarter ending period 3/31/08	21.66	15.03	18.48
2nd Quarter '08 10Q Filed on 8/1/08 Quarter ending 6/30/08	21.9	13.27	20.13
3rd Quarter '08 10Q Filed on 11/4/08 Quarter ending 9/30/08	9.17	9.91	8.89
2008 10K Filed on 2/25/09 Year ending 12/31/09	21.47	5.56	8.64

The Court's View: A Violation of Accounting Rules is Not Necessarily Actionable

The Securities Act and Securities Exchange Act were enacted to maintain public confidence in the marketplace and protect investors against securities fraud. (15 U.S.C.A. §77a, 15 U.S.C.A. §78a et seq) The test for whether a statement is materially misleading under section (b) is "whether the defendants' representations, taken together and in context would have mislead a reasonable investor." *McMahan,* (900 F.2d at 579) Plaintiffs' complaint set forth quotations from defendant's quarterly reports and other public statements alleged to be were materially false and misleading.

However, a key element to be alleged in the complaint brought section 10(b) and Rule 10b-5, is that the defendant made a false statement or omitted a material fact, with scienter, i.e. a knowledge of the fraud or a reckless disregard of the truth. (*San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.,* 75 F. 3d 801, 808 (2d Cir. 1996) Plaintiff's alleged that because defendants acted or failed to act despite their knowledge of the gap between the market value and the stockholder's equity, they had adequately alleged scienter.

The district court granted the defendant's motion to dismiss the Plaintiff's amended complaint for failure to allege facts supporting their claim with the particularity as required by Rule 9(b) and the Private Securities Law Reform Act of 1995.

The Court concluded that the complaint failed to specify a particular fraudulent concealed event or fact, unknown to the public, which would have prompted a company to test for impairment. The SEC filings as well as the market capitalization numbers were available to the public and therefore the plaintiff's gap theory was never concealed by the defendant. There can be no fraud if the information is public. The court also noted that the plaintiff relies on the difference between the stockholder's equity and market capitalization as a triggering event as articulated in GAAP that necessitates intra-annual impairment testing. However, the court concluded that GAAP provides guidelines and does not mandate intra-annual testing. The plaintiff never claimed a SEC regulation had been violated. Also, in the Court's view the company statements were merely estimates of the value of goodwill. It noted that goodwill is measured by individual reporting units at different times in the year and not a single calculation for the entire enterprise. Finally, because the plaintiffs relied on the difference in value of the stockholder's equity and market capitalization, the Court questioned the plaintiffs' theory of why the drop in the first quarter of 2008 necessitated a test for impairment of goodwill when in fact there was a drop at the end of 2007. Plaintiffs were never able to articulate a precise moment in time when they believed goodwill had been impaired.

With regard to scienter, the legal standard is that a "reasonable person [must] deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." The court found the plaintiffs did not satisfy this requirement.

On appeal, the Court of Appeals for the Second Circuit affirmed the district court's decision. The Second Circuit refers to its earlier decision in *Fait v. Regions Fin. Corp.* 655 F. 3d. 105, 112 that the plaintiff's must "plausibly allege that the defendants did not believe [emphasis added] the statements regarding goodwill at the time they made them."

Where Does This Leave Investors and Reporting Companies?

So where does this leave the investor who relied on the company's filings as to the value of goodwill? The 10K and 10Q still provide the window into a company's financial well being. A savvy investor would be wise to form his or her own conclusions of the value of goodwill when there is a difference in shareholder equity and market capitalization. The *CBS* Court refused to find fraud when the information was not concealed and available to the public. And finally after the initial purchase of a company, courts have recognized that the value of goodwill is an opinion and should be regarded as such, thereby giving almost not cause of action based on company statements.

An investors' section 10(b) or 10b-5 claim relying on violations of SEC regulations, or even a more tenuous failure to follow GAAP guidelines is not assured of success. The SEC was created to regulate the securities industry and thereby provide the public with confidence in investing, not to provide investors with a private right of action for violations of GAAP or, even SEC rules and regulations. GAAP standards have been accepted by the SEC in an attempt to give an investor confidence in the accuracy of 10Ks and 10Qs. In the present case, the plaintiffs were unable to plausibly allege company fraud by reason of an inflated goodwill value despite the company's refusal to follow the SFAS guidelines. The SEC never brought an action against CBS. The SEC acknowledges GAAP standards but does not accept them as a bright-line test. Courts do not accept that any and all violations of SEC rules and regulations give rise to a private right of action or a section 10(b) or rule 10b-5 claim.

The plaintiffs in *CBS* were unable to adequately allege their case through the company's many optimistic statements as compared to later lower numbers reported to the investing public. Although not expressly relied upon by plaintiffs, there is the underlying supposition that such a significant drop in goodwill must have been previously known to the company since there was no triggering event. At this time, courts seem reluctant to make the leap that a write-down of goodwill because of a sea change in customer preferences or competitive conditions necessarily means the officers and directors knew that such a write-down would become necessary at an earlier point in time. Section 10(b) and Rule 10b-5 remain anti-fraud provisions as to which *res ipsa loquitur* and other negligence doctrines have no place.

REFERENCES

City of Omaha v. CBS Corp., 2010 WL 1029290 (S.D.N.Y. Mar. 16, 2010); *City of Omaha v. CBS Corp.,* 2010 WL 3958849 (S.D.N.Y. Sept. 24, 2010)

In re Thomas, 24 B.R. 500, 500 Bankr. L. Rep. p. 78, 144 (E.D. Pa. 2000)

Rule 9(b) Fed.R.Civ.P. requires a plaintiff to allege fraud with particularity which has been practically interpreted to require the plaintiff to 1) specify the statements that the plaintiff contends were fraudulent,

(2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent. In addition the plaintiff must allege facts giving rise to a strong inference of recklessness or intent to deceive. In order to satisfy the fraudulent statement I'll check that this isn't scienter requirement, "a complaint may (1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness [emphasis added], or (2) allege facts to show that defendant had both motive and opportunity to commit fraud." *Rothman v. Gregor,* 220 F.3d 81, 90 (2d Cir. 2000).

SFAS 142 28
A reporting unit is a component part of a company working independently and having separate incomes and expenses which is recorded and regularly reviewed by management.

Statement of Financial Accounting Standards (SFAS) No. 141
Those standards are recognized as authoritative by the Securities and Exchange Commission (SEC) and were reaffirmed in its April 2003 Policy Statement.
Information can be accessed at http://www.nielsen.com/us/en/insights/top10s/television.html as of 10/2/12