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ADVOCATE'S EDGE

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GARIBALDI GROUP
Certified Public Accountants
Financial and Management Consultants

www.garibaldicpas.com

990 Stewart Avenue
Garden City, New York 11530

t: 516.288.7400
f: 516.288.7410
e: info@garibaldicpas.com

Using the “leakage” theory to show loss causation in securities litigation

Securities fraud cases rarely make it to trial, but those that do are often noteworthy. For example, a recent class action lawsuit gave the Seventh Circuit Court of Appeals the opportunity to weigh in on the “leakage model” for estimating stock price inflation. Although the court accepted the validity of the model, it imposed some restrictions on its use by adopting a burden-shifting analysis.

Case history

Glickenhaus & Co., et al. v. Household International Inc. was filed in 2002 under Section 10(b) of the Securities Exchange Act of 1934 and the SEC’s Rule 10b-5. The plaintiffs alleged that on numerous occasions the defendants, a consumer lender and its executives, had misrepresented its lending practices, delinquency rates and earnings.

At trial, the jury was asked to determine how much the stock was overpriced due to the misrepresentations. The plaintiffs’ expert presented two loss-causation models for measuring stock-price inflation: the specific disclosure and leakage models. The jury adopted the leakage model and awarded the plaintiffs $2.46 billion.

> The leakage model doesn’t account for the extent to which company-specific, non-fraud-related information might have contributed to share price decline.

Challenge to the leakage model

On appeal, the defendants attacked the evidence of loss causation. To prove causation, the plaintiffs needed to establish that the price of the stock they bought was inflated — higher than it would have been without the false statements — and that the price declined after the truth was revealed. According to the Seventh Circuit’s opinion, proving loss causation requires “sophisticated expert testimony, and the plaintiffs hired one of the best in the field.”

Using the leakage model, the plaintiffs’ expert calculated every difference, both positive and negative, between the stock’s predicted returns and its actual returns (during the disclosure period when the truth was revealed). The expert assumed that the total sum of these residual returns was the effect of the disclosures, while the amount the stock was overpriced on any given day was the sum of all subsequent residual returns.

Court clarifies liability for Rule 10b-5 "false statements"

The Seventh Circuit Court of Appeals in *Glickenhaus & Co. v. Household International Inc.* (see main article) also addressed what it means to "make" a false statement in connection with the purchase or sale of a security in violation of the SEC's Rule 10b-5.

The defendants argued that the district court erred by instructing the jury that the plaintiffs had to prove that the defendants "made, approved or furnished information to be included in a false statement of fact." They claimed that the "approved or furnished information" language misstated the law and essentially held them liable for false statements they didn't "make."

The defendants cited the U.S. Supreme Court case, *Janus Capital Group v. First Derivative Traders.* There, the Court found that someone who makes a statement must have ultimate authority over the statement, including its content and whether and how it's communicated. The district court reasoned that the ruling applies only to legally independent third parties, rather than to corporate insiders.

The appellate court interpreted the *Janus* holding to apply generally — not just to corporate outsiders. Thus, the high standard in *Janus* also applied to the corporate insider defendants, and the jury instructions, which used a lower standard, directly contradicted the high court's ruling.

The plaintiffs' expert found that the total sum of the residual returns during the relevant period was $23.94 per share. So if, on any given day, the sum of the subsequent residual returns exceeded this amount (due to the ups and downs of the market), the expert replaced it with this figure ($23.94).

The court noted that, though the leakage model accounts for market movement generally, it doesn't account for the extent to which company-specific, non-fraud-related information might have contributed to share price decline. The expert testified that he'd looked for such company-specific factors during the relevant period and didn't find any significant trend of positive or negative information — apart from the fraud-related disclosures.

The defense contended that any loss-causation model must fully account for, and exclude, any firm-specific, non-fraud-related factors that might have contributed to share price decline. But the court rejected this notion, instead settling on a burden-shifting "middle ground." Under this approach, if the plaintiffs' expert testifies that no firm-specific, non-fraud-related information contributed to the price decline during the relevant period and explains in nonconclusory terms the basis for this opinion, the defendants have the burden of identifying some significant, firm-specific, non-fraud-related information that could have affected the price. If they can't do so, the leakage model can go to the jury.

If the defendants can provide such information, the burden shifts back to the plaintiffs to account for it or present a loss-causation model that doesn't suffer from the same problem. The court suggested that an expert could avoid the issue by simply excluding from the calculation any days the defendants identified on which significant, firm-specific, non-fraud-related information was released.

The case continues

Although the appellate court upheld the viability of the leakage model, the plaintiffs didn't prevail. The court ultimately determined that the evidence didn't adequately account for the possibility that non-fraud-related information could have affected the share price decline. A new trial was warranted, consistent with the burden-shifting approach the court described. ■

IRS issues new guidance for attorneys' fees and costs in IRS proceedings

The IRS recently released final regulations (Treasury Decision 9756) concerning taxpayer awards of administrative costs and attorneys' fees under Section 7430 of the Internal Revenue Code. Sec. 7430 provides for awards to taxpayers for their reasonable administrative and litigation costs if they substantially prevail in most administrative and court proceedings involving the agency.

The IRS also released Revenue Procedure 2016-17, which provides more information detailing processes specific to pro bono representation. Several provisions are of particular interest to attorneys and their clients.

Net worth provisions

Sec. 7430 imposes net worth and size limitations on who can recover costs, and the final rules clarify several matters related to these limitations. For example, they provide that taxpayers' assets should be valued based on acquisition costs, rather than at fair market value (which proposed regulations would have required).

> The final rules and the revenue procedure include provisions concerning reasonable attorneys' fees for pro bono representation.

The final rules also clarify that, when taxpayers who file jointly also jointly petition the court and incur joint costs, each qualifies for a separate net worth limitation of $2 million, but the limitation will be evaluated together. In other words, they'll

satisfy the limitation if their combined assets are equal to or less than $4 million, regardless of how the assets are distributed. If they petition the court separately, each will be subject to a separate net worth limit of $2 million or less.

Administrative costs

The final regulations give a taxpayer 90 days to file an application to recover administrative costs from the date the IRS mails a final decision determining tax, interest or a penalty. Similarly, a taxpayer has 90 days to petition the Tax Court for a review of any final adverse IRS decision on an administrative costs award.

The regulations further clarify that a taxpayer may be eligible to recover reasonable administrative costs after the date of the first letter of proposed deficiency (the 30-day letter). But this is true only if at least one issue (other than costs recovery) remains in dispute as of the date the IRS takes a position in the administrative proceeding. If the IRS concedes an issue in the Office of Appeals before issuing a notice of deficiency or notice of the Office of Appeals' decision, the IRS is considered not to

have taken a position, and administrative costs aren't available.

Pro bono representation

The final rules and the revenue procedure include several provisions concerning reasonable attorneys' fees for pro bono representation. For example, the final rules eliminate a proposed rule that would have limited taxpayers' eligibility for an attorneys' fee award for pro bono representation based on their income and financial resources.

The final regulations also eliminate the proposed regulation that would have based the rate of compensation for pro bono attorneys who don't have a customary hourly rate on prevailing market rates. Instead, the revenue procedure provides that these attorneys receive the statutory rate unless they establish that a "special factor" (such as limited local availability of tax expertise) justifies a higher hourly rate.

Effective dates

The final regulations generally apply when a petition was filed on or after March 1, 2016, and taxpayers can apply them retroactively. Revenue Procedure 2016-17 applies to all motions for costs filed on or after February 29, 2016. It also can be elected for motions filed before that date if they're still pending before the court. ■

Technology's dark side: How to prevent ACH fraud

In the current technology-driven world, the convenience of instantaneous information and communication sometimes blinds us to technology's drawbacks, including cyberattacks and data breaches. But there's another lesser-known technology-enabled crime that your clients need to watch out for — Automated Clearing House (ACH) fraud — as they make daily debit and credit purchases.

What is the ACH?

The surging popularity of the ACH network is understandable. Consumers can use it to make electronic payments directly from their checking or savings accounts to other parties' accounts, eliminating the need to pay bills with paper checks or physical credit cards. Likewise, companies use the ACH for business-to-business transactions and to pay their employees, contractors and vendors.

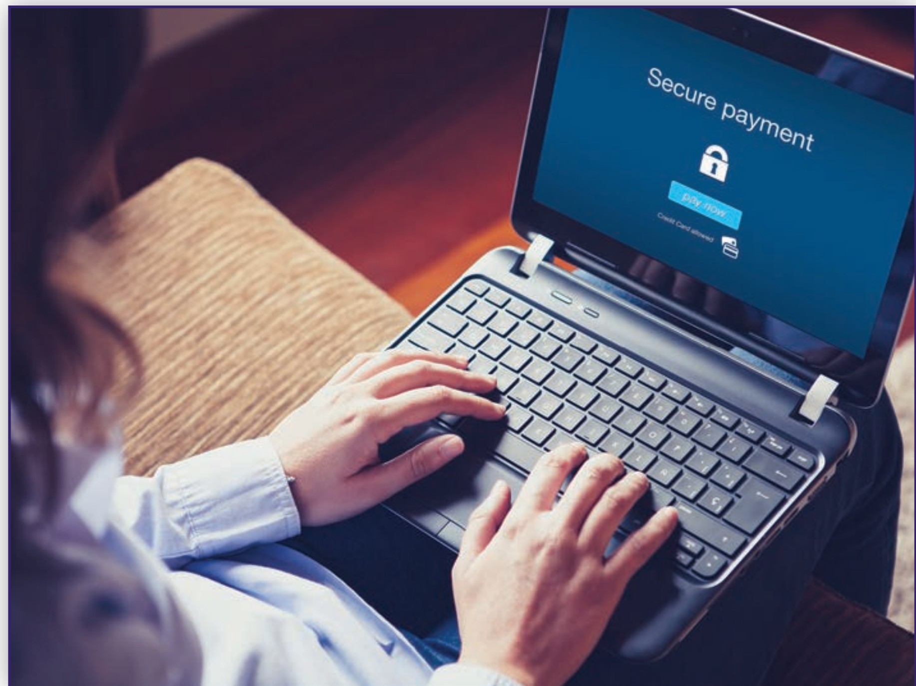
Businesses of all sizes can become ACH fraud victims, but small to midsize businesses may be most vulnerable. Even when they have substantial financial assets, these companies typically have fewer up-to-date information security measures in place.

How does fraud happen?

To commit ACH fraud, perpetrators need to obtain only an account number and bank routing number. This can be accomplished through phishing (using email to trick recipients into divulging personal data); legitimate, but hacked, websites; malware; and account hijacking.

For example, a thief might launch phishing attacks against a bank's customers. When recipients click on the link in the fake email, they're taken to a phony bank website and prompted to enter their

login information. The thief captures that information and uses it to access online banking accounts, and then initiates ACH payments to his or her own account at a different bank. Finally, the funds are transferred by wire to a third (in most cases, offshore) bank.



Alternatively, account holders might click on a link and unknowingly download malware that collects data they enter into Web forms, including those on banking sites. These individuals subsequently receive personalized emails that appear to be from companies with which they already have a relationship, asking them to reset their security code or personal identification number (PIN). By doing so, consumers install a virus on their computers. The next time they log into their bank's site, the virus executes commands that initiate fraudulent ACH transactions.

What can you do?

No single defense will provide complete protection for every individual and business that uses the ACH. But some simple steps can reduce the risk of fraud:

- Install firewalls and antivirus, antispyware, and antimalware software on computers and keep these programs updated,
- Ensure that every computer, smartphone and network you use requires a complex password that must be changed frequently, and
- Ignore unsolicited emails with attachments, links contained in the body of the message and pop-ups that request personal information.

Using a separate browser for online banking purposes, checking bank accounts daily for unauthorized activity, and accessing financial websites only by entering the URL (as opposed to using links in an email) also can help. Finally, consumers and employees need to monitor the performance of computers and devices. Slower processing, changing interfaces or repeated rebooting can indicate the presence of malware or a virus.

Companies also can decrease fraud vulnerability by using daily account reconciliations and positive-pay methods. Positive pay checks a company's requested ACH transactions against existing ACH transaction filters. If the transactions fail the test, the bank makes the company aware of this and allows the company to approve or reject them. Customer participation is key in ensuring these strategies are effective.

Reducing vulnerability

As paper-based payments go the way of the dinosaur, it's important to stay ahead of the latest new forms of technology-enabled crime. ACH transaction fraud can be disastrous for its victims. But by using some of the strategies mentioned here and others, your clients can reduce their risk and ensure their everyday ACH transactions go forward unimpeded. ■

The cost of equity

Does size matter in business valuation?

Thirty-five years ago, Dr. Rolf Banz of the University of Chicago first identified what he called the "size effect." He conducted research that revealed that smaller firms had higher risk-adjusted returns on average than larger firms. Based on this finding, some business valuators apply a "size premium" (also known as a small cap premium) when estimating the cost of equity. The underlying theory is that investors might require additional returns for increased risk associated with investments in smaller companies. But whether the premium is appropriate remains subject to debate.

Applying the premium

The cost of equity is a component of discount rates used in discounted cash flow analyses. It captures the returns investors require for holding shares of stock in the subject company. In his 1981 study, Dr. Banz noted that valuators, when estimating the cost of equity, assume a simple linear relationship between the expected return and the risk. That is, the required return increases proportionally to increases in risk. But he found that systematic risk explained only part of the higher returns generated by smaller companies.

The size premium is intended to account for the incremental returns that investors in small firms require. A valuator who applies a size premium when valuing a smaller company generally adds it when using the capital asset pricing model or a build-up model to estimate the cost of equity. This increases the discount rate and reduces the value, if all else is the same.

Debating the issue

Questions have arisen over the validity of Dr. Banz's findings today. Some have noted, for example, that studies finding statistically significant evidence of a size premium usually relied on data from before 1981. But some research conducted with data from after 1981 suggests that a statistically significant relationship no longer exists.

Other research suggests that the size premium still exists if historical data on returns is modified to adjust for company-specific factors. Examples of these qualitative factors include profitability, growth and stability of earnings. The research asserts that, once these factors are adjusted for, the size premium is indeed real.

Proceeding cautiously

The question of whether investors require size premiums to compensate them for investing in small companies remains unsettled (as does, for that matter, the question of what qualifies as "small"). If the use of a size premium comes up in litigation, it's essential that your valuation expert understand the relevant issues in this ongoing debate and can defend his or her position with the latest market research. ■

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GARIBALDI GROUP

Certified Public Accountants
Financial and Management Consultants

990 Stewart Avenue | Garden City, New York 11530

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Tel: 516.288.7400 • Fax: 516.288.7410 • garibaldicpas.com