Securities Litigation Implications Of COVID-19 Impairments

By Adrienna Huffman and Bin Zhou (November 3, 2020)

Thus far in 2020, six banks wrote down $6.3 billion of goodwill in the first quarter,[1] and Baker Hughes Inc. disclosed a $15 billion goodwill impairment in April.[2] The Wall Street Journal reports that U.S. companies have impaired $261 billion in assets, including goodwill, in the first half of 2020.[3]

According to a recent news report, the U.S. Securities and Exchange Commission is asking many companies to provide more detailed analyses justifying their decisions not to report goodwill impairment despite large drops in their stock prices.[4]

Given the economic slowdown caused by the COVID-19 global pandemic, goodwill impairments remain a key financial reporting issue in the near future, especially in industries hit hardest by the global pandemic and for companies with active M&A activities in the not so distant past.[5] Moreover, goodwill write-downs might also be spurred by firms taking a "big bath" — i.e., the impairment of goodwill during quarters when earnings are already expected to be weak.

What does this imply for securities litigation? What claims could plaintiffs bring? What are the likely arguments for and against such claims? In this article, we draw a parallel between the current environment and the aftermath of the 2008-2009 Great Recession.

Triggering Events of Goodwill Impairment

Goodwill, in accounting, is an intangible asset created when a company makes an acquisition and pays more than the fair value of the target's net identifiable assets — assets less liabilities. The excess payment represents the value the acquirer expects to derive from the acquisition, possibly through ownership of contracts in process or assembled workforce in-place. After recognition, under the current U.S. accounting rules, goodwill is tested for impairment at least annually, or more frequently if other indications arise.

One such indicator is a substantial decline in the company's market value. Research finds that the disclosure of a goodwill impairment is usually associated with a sharp stock price decline, as it often signals an acquisition is performing below management's original expectations.[6]

When this happens, the goodwill is deemed impaired and will be written down to the estimated fair market value.[7] The impairment charge, or the difference between the original carrying value and the new lower fair market value, is recognized in earnings.

A practical rule of thumb or a reasonable indicator of a goodwill impairment is when a firm's market-to-book ratio falls below one.[8] Recent research confirms that (1) goodwill impairments often ensue after firms' market-to-book ratios fall below one; and (2) some firms appear to be pressured into recording goodwill impairments even when the impairments are not substantiated by economic fundamentals.[9] For this reason, goodwill impairments are more likely to occur during economic downturns.
Goodwill Impairment-Related Securities Litigation From the 2008-2009 Financial Crisis

The expected increase in goodwill impairments related to the global pandemic is also expected to trigger securities litigation, similar to what occurred during the Great Recession.

We identified and reviewed 20 securities-related lawsuits filed in the state of New York that cite goodwill impairments as part of the plaintiffs' claims against the defendants. A typical claim is that the recognition of goodwill impairment was delayed, and consequently shareholders suffered damages when they purchased shares at the inflated prices.

Our analysis indicates that most cases are dismissed, most often for failure to establish scienter, as estimates of fair value used to assess goodwill are subjective.

As U.S. District Judge Naomi Reice Buchwald of the U.S. District Court for the Southern District of New York stated in In re: ForceField Energy Inc. Securities Litigation in 2017:

Where an omission is based on an accounting write-down's timing, it is not sufficient to simply allege the write-down should have occurred earlier; instead the complaint must include "factual allegations from which a reader could infer Defendants intentionally or recklessly failed to take write-downs" when they should have.[10]

Indeed, in another widely cited decision, Fait v. Regions Financial Corp., U.S. District Judge Lewis A. Kaplan of the same New York federal court stated:

[T]he value of such assets is a matter of judgment and opinion. This is quite significant. Given the lack of any objective or readily determinable value for the [assets at issue], "the question of material falsity" of the stated goodwill "is whether the representation was false — not because the value [was] 'wrong' in some empirical sense, but because" the financial statement in the 10-K did not reflect management's "honest opinion."[11]

The case was dismissed, in part, on these grounds.

Where plaintiffs might gain traction in goodwill impairment-related securities litigation, then, is at the confluence of timing and managerial incentives. The academic literature points to several incentives that may impact a manager's decisions to delay, mask, or even hide goodwill impairment.

First, firms' senior executives may have incentives to delay a company's goodwill impairment because CEOs' salary plus bonus and option-based compensation are often substantially reduced following a goodwill impairment.[12] Further, senior executives' reputational concerns and preference for smooth earnings could also influence decisions on whether and when to recognize a goodwill impairment.[13] Of course, incentives to delay a goodwill impairment should not be conflated with a genuine belief that the business was only temporarily affected and remains fundamentally strong.

Second, management may have the incentive to camouflage goodwill impairments with other bad news, especially industrywide news outside of management's control, akin to the idea of a big bath — something the academic literature refers to as an earnings management technique where firms will take large write-downs during quarters where they are reporting weak earnings.[14]
Indeed, a recent news article predicted that asset write-downs, such as goodwill impairments, related to COVID-19 would cause big bath earnings drawing trends to the Great Recession.[15] If a firm experiencing operational declines was looking to delay its goodwill impairment opportunistically, it might find the timing of COVID-19 a perfect opportunity to take a big bath and cover for the otherwise misleading write-down.

Third, other incentives to delay include typical fare for securities litigation — firms might delay recognition of an impairment before an equity or debt offering or initial public offering. Indeed, of the cases we reviewed from the New York state, one case that was not dismissed successfully — Kirkland v. Wideopenwest Inc. in the New York Supreme Court — alleged that the firm failed to timely evaluate and impair its goodwill in anticipation of the firm's IPO.[16]

**What to Expect With Goodwill Impairment Litigation in the Near Future**

The trend in goodwill impairments will continue as the global pandemic takes its toll on the global economy. Market-driven impairments are unlikely to result in successful plaintiff claims against a company, especially if other companies in the same industry are also impairing goodwill. However, litigation might have more teeth when a company delays an impairment due to senior management's personal, financial and/or reputational concerns — or uses a big bath to hide it — particularly when the economic fundamentals indicate that the asset was impaired.

We expect the more successful cases need to provide factual evidence that the firms intentionally delayed recognition of an impairment in clear violation of accounting rules. Qualitative information will also be key to establishing that management was aware that the economic fundamentals of the reporting unit declined and still decided to avoid or delay impairment.

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[5] For this reason, the Securities & Exchange Commission (SEC) provided disclosure guidance in light of the evolving pandemic recommending firms to "consider their disclosure obligations, questions to consider with respect to their present and future operations include: ... Do you anticipate any material impairments (e.g., with respect to goodwill, intangible assets ... that have had or are reasonably likely to have a material impact on your financial statements?" See U.S. SEC, Division of Corporation Finance, "CF Disclosure Guidance Topic No. 9," March 25, 2020, https://www.sec.gov/corpfin/coronavirus-covid-19.


