



Financial Experts May Be Instrumental at Initial Stages of Sec. Litigation

Fulton Co. Employees' Retirement System v. MGIC Investment Corp., 2010 WL 5095294 (E. D. Wis.)(Dec. 8, 2010)

In the wake of the recent financial crisis, current securities fraud litigation focuses on whether shareholders can show that a company's failure to write down impaired assets caused the loss of share value. Under tightening federal standards, however, the complaint may not survive a motion to dismiss if the plaintiffs fail to enlist a financial expert to help them evaluate and apply certain fair value accounting concepts and techniques in the initial allegations.

Subprime venture collapses in 2007. The plaintiffs in this case were institutional investors in the defendant, which in turn owned a 46% interest in a private venture that held \$8.8 billion of mortgage-backed securities (MBS). As the subprime crisis began to unfold in early 2007, the defendant engaged in a "fraudulent scheme" to inflate the value of its holdings by failing to report their impairment according to the then-applicable financial accounting standards (FAS 115 and 157), according to the plaintiffs. When the private venture collapsed in August 2007, the defendant wrote off its entire investment of \$516 million, leading to substantial loss of shareholder value.

The defendant filed a motion to dismiss the claims, arguing that the plaintiff failed to plead sufficient facts showing that the assets were not valued properly for financial accounting purposes. "This type of valuation is not an exact science," the federal district court observed. "Rather, these principles tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." Accordingly:

It is important to recognize that there was no single value that could have been applied to [the MBS] portfolio and deemed the "true value" of the portfolio during the first half of 2007. Instead, there was a range of reasonable valuations, and statements that reported the value of the portfolio could have been false only if the reported value was not within the range.

Accordingly, the complaint must allege that the reported valuations were outside the reasonable range, in this case by 1) identifying the accounting principles that govern the valuation of the MBS portfolio; and 2) pleading facts that give rise to a reasonable belief that the defendants did not properly apply such principles. Moreover, because the valuation of the subprime portfolio fell on the "extremely difficult end of the [valuation] spectrum, due to the limited number of observable transactions involving such assets," the complaint had to contain enough background information to enable the court to conclude that a fraudulent statement (or omission) regarding asset value had occurred. It is not enough merely to list the asset values and then simply assert that they were not reported at fair value, the court explained. Instead, the plaintiff "must take the pleaded facts, run them through the fair-value machinery, and show that one could not reasonably come up with the values that the defendants reported," the court held.

In this case, nothing in the allegations informed the court whether the reported values were justifiable, or what magnitude of write-offs should have been taken. The plaintiffs offered the statements of a confidential witness to show that the portfolio was overvalued—but they failed to indicate that the witness had any financial accounting expertise or was familiar with fair value determinations of subprime assets. The complaint also failed to allege that the witness had competently formed his opinion “or that his understanding of ‘value’ was in any way similar to the accounting concept of fair value,” the court held, in dismissing the entire suit.