SIMPSON THACHER MEMORANDUM

Securities and Exchange Commission v. *BankAtlantic Bancorp, Inc.*: Some Guidance on MD&A's "Known Trends or Uncertainties"

February 19, 2014

The Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is required to, among other things, "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[1] In *Securities and Exchange Commission* v. *BankAtlantic Bancorp, Inc.*, decided in October of 2013, the United States District Court for the Southern District of Florida helped shed some light on this requirement, which can sometimes be a source of uncertainty for publicly traded companies.[2]

I. FACTS

In the *BankAtlantic Bancorp* case, the Securities and Exchange Commission ("SEC") brought suit against the bank holding company BBX Capital Corporation (formerly known as BankAtlantic Bancorp, Inc.), as well as its Chairman of the Board and CEO, for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5. The claims were based, in part, on the company's failure to disclose in its MD&A significant declines in the credit quality of loans in its commercial real estate land acquisition and development portfolio ("Commercial Residential Portfolio").[3]

In 2006 and 2007, BankAtlantic's Loan Review Department noticed three negative trends in the Commercial Residential Portfolio: (1) slowed absorption in the sale of lots or homes by borrowers, resulting in more borrowers requesting extensions on their loans; (2) depletion of loan-interest reserves; and (3) a downgrade of some of BankAtlantic's loans to "substandard" ratings.[4] BankAtlantic's management was aware of these trends, as evidenced in various internal emails expressing concern regarding the credit worthiness of the company's Commercial Residential Portfolio. Nonetheless, the MD&A sections of the company's 10-Qs for the first and second quarters of 2007 omitted any reference to the downgrading of loans or to

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[1] 17 C.F.R. § 229.303(a)(3)(ii).

[2] *See Securities and Exchange Commission* v. *BankAtlantic Bancorp, Inc.*, 2013 U.S. Dist. LEXIS 146699 (S.D. Fl. Oct. 10, 2013), *motion for reconsideration denied*, 2014 U.S. Dist. LEXIS 11229 (S.D. Fl. Jan. 30, 2014).

[3] The SEC also claimed that defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 by virtue of (1) the allegedly false statements they made in earnings calls with investors and analysts, and (2) their failure "to accurately account for loans as held-for sale." *Id.* at *26.

[4] *Id.* at *10-*11.

the overall declining credit quality of the loan portfolio. The MD&A sections simply stated that if the properties are not acquired as anticipated, the company "anticipate[s] that the borrower may not be in a position to service the loan," and that if the real-estate market declines, higher credit losses in the Commercial Residential Portfolio may result.[5]

The defendants in the action moved for summary judgment on all of the SEC's claims; the SEC moved for partial summary judgment, *inter alia* on the defendants' affirmative defense that they acted in reliance on the professional advice of their accountants.

II. THE COURT'S RULING

With regard to the MD&A disclosures in the company's quarterly filings, the court opined that "[t]he disclosure of the possibility of a future risk does not disclose the existing, observed decline in credit quality in the Bank's Commercial Residential Portfolio."[6] The court explained that the loan portfolio "was already negatively impacted by slowed absorption, depleted interest reserves, and requests for extensions," manifesting in the increasing number of loan downgrades, and that the company was aware of all of these trends yet chose to remain silent about them in their filings.[7] Because, according to the court, the concerns expressed by management in their internal communications create issues of fact regarding whether the negative trends were material and whether the defendants acted with scienter, the defendants were not entitled to summary judgment.

In response to the SEC's motion for partial summary judgment, the court addressed the defendants' affirmative defense that they relied in good faith on the professional advice of their accountant, Pricewaterhouse Coopers ("PwC"), in excluding the necessary disclosures from their MD&A.[8] The court explained that in order to establish "a reliance-on-professional-advice affirmative defense in the case of an accountant, a defendant must show that he (1) completely disclosed the issue to an accountant; (2) sought [professional accounting] advice as to the legality of his conduct; (3) received advice that his conduct was legal; and then (4) relied on that advice in good faith."[9] In this case, however, the court held that it was undisputed that:

1. the defendants did not share the disclosure issue with PwC – PwC had neither the underlying source documents that management possessed, nor the internal communications exhibiting management's concern over the declining credit quality of the Commercial Residential Portfolio; and

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[5] *Id*. at *20-*21.

[6] *Id*. at *35.

[7] *Id*.

[8] As a general matter, evidence of reliance on the advice of a professional (such as an accountant or attorney) may, in certain circumstances, be presented to refute proof of scienter in a securities fraud action under Section 10(b) of the Exchange Act and Rule 10b-5. While some jurisdictions consider reliance on professional advice to be an affirmative defense, others take it into account among other relevant factors in determining whether the defendant acted with intent to defraud.

[9] *Id*. at *59 (internal quotations and citations omitted; brackets in original).

2. the defendants "did not receive actual accounting advice from PwC with regard to their disclosures" – not only was PwC not asked for its advice on the matter, but its engagement did not include the verification of underlying statements by management.[10]

Thus, the court held, "PwC did not certify the accuracy of the disclosures in the 10-Q's."[11] Consequently, the defendants were not entitled to advance the reliance-on-professional-advice affirmative defense.

III. SIGNIFICANCE OF THE DECISION

Determining which "known trends or uncertainties" public companies are obligated to disclose in their MD&A requires careful analysis of the unique, relevant facts in each case. The court's ruling in *BankAtlantic Bancorp*, however, provides some important general guidance:

- The content, tone, and/or frequency of internal discussions regarding a certain known trend or uncertainty could signify its materiality; a trend that is discussed internally should, therefore, be considered in a disclosure analysis for MD&A purposes.

- The obligation to disclose "presently existing" material trends is not fulfilled through language regarding potential future risk.[12]

- Blind reliance on accounting firms which are given incomplete information and/or are not requested to provide an opinion regarding the duty to disclose certain trends will not excuse a registrant's failure to disclose these known trends or uncertainties.

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If you have any questions or would like additional information, please do not hesitate to contact Yafit Cohn at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

[10] *Id*. at *64-*65.

[11] *Id*. at *66.

[12] *Id*. at *48.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000