RULES OF THE ROAD FOR
RESTATEMENTS

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2006 demonstrates that restatements are here to stay – they are a fact of corporate life. 1,244 U.S. public companies and 112 foreign private issuers filed a total of 1,538 restatements in 2006. The number of U.S. companies restating in 2006 compares to 1,159 in 2005, 589 in 2004 and 480 in 2003. Since the Sarbanes-Oxley Act (“SOX”) became law in July 2002, we have gone from approximately 4% of public companies restating in 2003 to approximately 10% restating in 2006.

Multiple reasons have been offered for the increase:

- SOX, particularly Section 404, has caused companies to design and implement new systems and develop and standardize practices, procedures and programs for internal control over financial reporting that have uncovered errors in historical as well as current financial statements, because of what many viewed as historical neglect of corporate infrastructure and what others termed a historic shift in requiring more than was necessary for internal control over financial reporting.2

1 Unless otherwise noted, all statistics on restatements are from Glass Lewis & Co. “The Error of Their Ways” published on February 27, 2007 (hereinafter “Glass Lewis”). Audit Analytics publishes similar surveys and has different numbers with 1,591 companies filing 1,876 restatements in 2006. Under either system, 2006 was a record. The disparity between the number of companies and the number of restatements results from the fact that 116 companies filed multiple restatements in 2006. Large numbers of companies restating a restatement is a new phenomenon. In 2005, only seven did so. Glass Lewis at 5.

2 As stated by Mark Olson, Chairman of the Public Company Accounting Oversight Board (the “PCAOB”), “In June, ‘AS2’ will go away and we’ll have a new standard that will go to the SEC for approval.”… “It will describe how you can identify the controls that really matter.” Neal St. Anthony, “Chief overseer aims to ease Sarbanes-Oxley: A former Minnesota banker heads the agency that supervises accounting firms. He favors some relaxation of the antifraud law,” Star Tribune, Business Insider Section (April 9, 2007).
• The demise of Arthur Andersen LLP has resulted in some auditors adopting a “take no risk” policy; many chief financial officers believe that engagement partners are in search of the perfect audit, one where any error can be viewed as grounds for restatement.3

• GAAP has become so complex that no one can get it right all the time and for certain issues there is no clearly right answer.4 Very few companies have the resources to have a specialist in every aspect of GAAP.

• Transactions have become even more complex which can result in lessening the ability of accountants to ferret out every accounting issue even when they are shown the contracts before they are signed by the business people.

• FAS 154, Accounting Changes and Error Corrections, adopted by the Financial Accounting Standards Board which took effect in mid-2005 to hasten convergence with international accounting standards has confused investors who cannot differentiate a restatement resulting from an error from one resulting from a change to a more preferable accounting standard5 and has limited the alternatives to a restatement by eliminating the ability of in-house accounting staff to take a cumulative catch-up under old APB 20, Accounting Changes.

• Public companies did not historically devote adequate time, effort or expense to the accounting function or internal audit function are now playing catch-up under far stricter regulatory scrutiny from the courts and the Department of Justice in addition to the SEC.

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3 The Public Company Accounting Oversight Board has an enforcement capability that is directed at the outside auditor, rather than the company.
5 In April 2007, the Public Company Accounting Oversight Board published for comment a proposed standard, Evaluating Consistency of Financial Statement, to respond to FAS 154 and help investors discern why a change in the financial statements occurred.
• Practices that were acceptable in the past, such as sloppy procedures for granting options, are now the subject of close scrutiny by auditors and regulators.\(^6\)

• Since the scandals of Enron and WorldCom, the Department of Justice and state attorneys general have brought a criminal focus to what previously had been almost exclusively the domain of civil liability and the SEC which has resulted in a propensity to err on the side of a restatement, rather than to take a chance of being second-guessed down the road.

• SAB 99 has ‘dumbed down’ the definition of materiality from a standard of “what a reasonable investor would consider important”\(^7\) in making an investment decision to “what she might want to know” or “what he ought to know in making an investment decision.” Some people think that since the standard for what’s important is so low under SAB 99, it doesn’t take very much to have an error result in a restatement.

While no single reason or combination of reasons has emerged as “the” cause for the surge in restatements, one thing is clear: restatements have not decreased in the five years since SOX became law.\(^8\)

Given that almost one in ten public companies restated its financial statements in 2006, the ongoing wave of options backdating, the focus on non-options accounting issues, such as FIN 48, EITF 00-19 and cash flow statements, as well as the expected application of Section 404 to smaller public companies, 2007 looks like another year for a high volume of restatements by public companies.

\(^6\) As one CFO remarked on a panel, “What keeps me up at night is what I am doing now that is perfectly acceptable today, but will be illegal five years from now.”


\(^8\) Significantly, the type of company restating financial statements may be changing. Restatements by public companies with a market capitalization of at least $750 million decreased from 238 in 2005 to 209 in 2006, while restatements by companies with a market capitalization of less than $75 million increased from 633 in 2005 to 884 in 2006. While the smaller companies haven’t had to comply with Section 404 of SOX yet, perhaps the increase for smaller companies is a harbinger of what will happen when the SEC requires them to do so.
Here are my Rules of the Road for Restatements:

1. Once an issue comes to your attention, you should consider the following at the beginning of the process, before any decision to restate has been made:

   • Identify the issues, recognizing that the issues you start out with may change during the process. Be sure to follow all the flags, especially red ones.
   • Implement procedures to retain documents, especially e-mail.
   • For each issue, find out all of the facts including:
     o What is the issue?
     o Is it still happening or did it only happen in the past?
     o Could it happen again?
     o When and where did it happen?
     o Why did it happen?
     o What are the collateral issues that relate to it?
     o Who was or is involved?
     o How did it happen and how does it affect your financial statements?
   • With the facts in hand, determine whether the issues complied with GAAP and GAAS and if not, identify how, where and when they did not comply and how it should be classified under SFAS 154, e.g., an error, change in estimate or change in accounting principle.
   • If there were errors within the meaning of paragraph 2.h of SFAS 154, were they material under SAB 99? Be prepared to conduct a detailed SAB 99 materiality analysis and to provide a SAB 99 memo to the audit committee of the board of directors. If the errors are identified as the result of a review by the Staff of the
SEC’s Division of Corporation Finance (the “Staff”), be prepared to provide the SAB 99 memo to the Staff.

- How can the errors be corrected? Conduct an analysis under paragraph 25 of SFAS 154 to determine whether a restatement is required. Also consider whether paragraph 29 of APB 28, “Interim Financing Reporting” or Staff Accounting Bulletin No. 108⁹ is applicable, and, if so, how it can be implemented.

- If there were errors, were they caused by one or more people who knew or should have known what they were doing? Did they have a reckless disregard for what they did or failed to do? Were they aware of the consequences of their actions? Did they benefit from their conduct and, if so, how? Consider whether and how Section 304 of SOX could apply.

- If a restatement is required, what periods and what filings are involved? Are you able to estimate the time and resources necessary to prepare and audit restated financial statements? In terms of personnel devoted to the process, don’t be penny wise and pound foolish. While the working group should be kept as small as possible and totally committed to resolving the issue, it must be big enough to get the job done. If you don’t have sufficient staffing to complete the process, retain additional permanent or temporary employees or another accounting firm as soon as possible so that the management does not become a bottleneck in the restatement process.

- If a restatement is required, it is important to understand that the company may not be able to conduct business as usual, especially given the diversion of management’s attention.

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⁹ Staff Accounting Bulletin No. 108 (“SAB 108”) is attached as Appendix 1.
• Get the support of senior management, especially the chief executive officer, and the
audit committee to get the job done, fully and completely the first time to avoid a
restatement of a restatement. The commitment should be to get it done right as
quickly as possible, not to get it done as quickly as possible.
• Did the company (or any insiders) sell securities during any of the periods at issue?
• Review your D&O insurance policy and indemnification provisions with this fact
pattern in mind.
• How will the facts affect internal control over financial reporting, Section 404
compliance, disclosure controls and procedures or certifications under Sections 302
and 906 of SOX? Is your documentation adequate and are your systems sufficient to
retrieve dependable information in a timely, efficient and reliable manner?
• Although practice varies, the audit committee should reach the conclusion that
previously issued financial statements cannot be relied upon for purposes of
Item 4.02(a) of Form 8-K and that a restatement is required.
• What disclosure should be made? Paragraph 26 of SFAS 154 may only be the
starting point. When and how? See Rule 2 below.
• Expect the Item 4.02 of Form 8-K you file to be reviewed promptly after filing
(typically within two business days of filing) by the Staff and expect to receive a
comment letter. Experienced counsel can help minimize or pre-empt Staff comments.

2. Remember the Goldilocks Rule of Disclosure: not to early, not too late – time your
disclosure just right. What this means is to go through an analysis before putting out the
first press release. While you don’t have to disclose until it’s ripe to do so, time is of the
essence, so don’t delay disclosure unless it is necessary. For example, once you become
aware of the possibility of a restatement, don’t say you are going to restate unless a
decision has been made that you are going to restate. You don’t have to restate unless
your financial statements are wrong and wrong to a material extent. So, examine all
aspects of materiality. SAB 99 memos have become commonplace in conducting this
analysis. Look at the accounting alternatives to a restatement, like paragraph 29 of
APB 28, “Interim Financial Reporting,” and SAB 108. Be sure that your people
understand the “reasons behind the rules and how they were violated”10 especially if you
are going to hold an analyst conference call to discuss the restatement. In addition, try to
get your arms around “the why” as well as “the what.” Is the restatement due to an
innocent error or financial fraud or something else. Remember to close the trading
window, shut down your shelves, and inform your commercial bank lender and rating
agencies before the press release is issued. Be careful in doing so, because a leak may
result in you having to make disclosure before you are ready to do so. Given the close
relationship between a restatement and a SEC Enforcement inquiry, consider calling the
Division of Enforcement and providing them with the press release you are publishing,
not to get their comments but rather to show them that you are following the right
process.

When you do issue your press release, make sure it has full, fair and complete disclosure
and that it anticipates, to the extent possible, questions you may be asked by the market.
Since the market hates uncertainty, try to anticipate questions about the restatement and
include the answers in the press release. While people will press you to say what the
restated numbers will be, don’t disclose the numbers or ranges of numbers on a restated

10 Lessons from Fannie – Bob Blakely’s Tips on Restatements, in CFO.com at
basis unless you (and your auditors) have a high degree of confidence that they represent the best current estimate of what the restatement will look like. Don’t guess what the restated numbers will be. When in doubt, leave it out. If the question is important enough to answer, consider putting it into the press release.

If you are going to have a conference call, make sure your preparation anticipates the questions you will answer and those which you have to defer because the restatement process is in its early stages. Think about how you are going to answer tough questions that may not answered in your press release because they currently have unfavorable answers, such as “Is there fraud?” “Is anyone being terminated?” “Is there a disagreement with your auditor?” “Is the SEC conducting an investigation?” If you are going to use Q&A’s for employees, make sure the Q&A’s don’t have material facts that aren’t in the press release.

Although the Staff comment letter on your Item 4.02 Form 8-K and the SROs may want you to disclose the date when you will issue restated numbers, try not to do so. Don’t promise anything in your press release about the restatement, especially the time when it will be completed. Think about the effect of a restatement on your guidance. Don’t provide or reaffirm guidance in your press release unless you are confident it can be met.

Regardless of whether you publish guidance, remember to include a customized safe harbor statement to get the benefit of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

In making public disclosure, understand your different audiences, such as investors, customers, suppliers, employees, joint venture partners and regulators from the SEC through the SROs. Balance all these interests with Regulation FD, Rule 10b-5,
Regulation G and Item 10 of Regulation S-K, SAB 99 and the duty to update. In making disclosure, understand the tension between a “self-fulfilling prophecy” and full and fair disclosure.

If your press release also relates to the late filing of a periodic report, coordinate your disclosure with Form 8-K and Form 12b-25. Understand that your Form 12b-25 disclosure will form the core of your press release and bear in mind that Form 12b-25 is a disclosure document, not simply a notice. Don’t forget Spiegel.\textsuperscript{11}

If the restatement process is taking an extended period of time to complete, determine what your disclosure policy is going to be until you do file your restatement. Are you going to go radio silent after the initial press release or file press releases with each detailed Form 12b-25 as the restatement process progresses. Recognize the pros and cons of each approach such as: if the facts are not ripe, they can change and new issues can arise, resulting in an interim press release subsequently being viewed as misleading. Moreover, interim press releases may exacerbate updating issues.

How are you going to handle analysts? Major shareholders and institutional investors? Are you going to have analyst calls at the initial announcement only or with the filing of each Form 12b-25? Have you typically held them in the past? Understand that the Form 8-K rules still apply to you even though you haven’t filed one or more periodic reports.

3. Talk to the SEC, your SRO and your rating agencies before or at the time you issue your press release. Expect the SEC’s Division of Enforcement to open an investigation, if your press release says you are going to restate. Cooperate with the SEC.

litigation, especially if your stock price drops when the press release is issued. Given the prospect of a SEC investigation and private litigation, it is prudent to involve litigators from the beginning.

Remember your listing requirements, especially if you are going to file or be late in filing periodic reports. While the restatement process may seem too slow and never ending, the SRO delisting process can be too fast and result in adverse decisions before you are able to finish the restatement process. If you file a Form 12b-25 and state that you do not expect to file by the extension date, expect to have your SRO, particularly The NASDAQ Stock Market, begin a delisting proceeding promptly after your initial announcement. The SRO notification letter can result in further disclosure and a SRO hearing process, which can happen as soon as a month after your initial press release. While NASDAQ’s process is triggered by a missed Form 10-Q, the New York Stock Exchange process focuses on a missed Form 10-K and in the past has been a more flexible process. Recent events have caused NASDAQ to change its traditional delisting process for companies with options dating issues.

4. Identify and analyze the collateral effects that an accounting, late filing or control deficiency can have on:

- Your company’s business – for example, if royalty payments to a third party are based on revenue or net income from a product and the amounts are being restated,

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12 In 2006, the median stock return on companies that restated financial statements was a negative 6%. Glass Lewis at 1.


are subject to change or are not being published because periodic reports are not being filed, anticipate the issues with the third party, rather than run the risk of a breach of contract. Understand what the effects can be.

- Bond rating downgrades – as an example, Fitch Ratings downgraded American International Group, Inc.‘s debt because the annual report was delayed and Standard & Poor’s downgraded the debt because of internal control over financial reporting not because a $1.7 billion restatement was material. A downgrade in the credit rating can result in higher cost of capital because investors will demand to be paid higher interest rates, which in turn increases expenses and the cost of doing business which can make the company’s products less competitive.

- Indenture default – The court in The Bank of New York v. Bearing Point, Inc., Index No. 600169/06 (Sup. Ct. N.Y. Sept. 18, 2006) (hereinafter “Bearing Point”) held that Bearing Point’s failure to file annual and quarterly reports with Bank of New York, the indenture trustee, in accordance with an indenture provision, breached the indenture and constituted a default which obligated Bearing Point to accelerate principle and accrued interest. While the emerging consensus is that this case is wrongly decided, it has caused at least one other company to file a declaratory judgment action and still other companies to arrange bridge financing when they

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15 The opinion is attached as Appendix 2.

16 Section 5.02 of the Bearing Point indenture, titled “SEC and Other Reports,” stated:

[T]he Company shall file with the Trustee, within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and of the information, documents and other reports (or copies of such portions of any of the foregoing the SEC may by rules and regulations prescribe) which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of TIA Section 31.4(a)

Bearing Point at 5.

fail to file a periodic report with the SEC and an indenture trustee in situations where the indenture has similar language to that in Bearing Point.

- Bank credit agreement – securing a waiver from lenders in a credit agreement may be easier to do than convincing a trustee that no default has occurred in an indenture with a provision similar to that in Bearing Point, especially if hedge funds hold or are purchasing the debt.

- Form S-8 availability – the Staff’s position is that the failure to file one or more Form 10-Qs does not necessarily mean that your Form S-8 can no longer be used, if counsel determines that the disclosure is still useable which means that the company still has a valid prospectus under Section 10(a) of the Securities Act of 1933 and that the company is able to determine that it has no concerns under Section 12(a)(2) of the Securities Act or under the antifraud provisions of the federal securities laws. Failure to file a Form 10-K can lead to a different result if the sixteen month period of Section 10(a)(3) under the Securities Act of 1933 has elapsed. So, the failure to file a Form 10-K after the required due date does not, in itself, mean that the Form S-8 is no longer useable, so long as the company concludes it still has a valid prospectus under Section 10(a) of the Securities Act and has no concerns under Section 12(a)(2) of the Securities Act or the antifraud provisions of the federal securities laws. However, the use of the Form S-8 would be suspended if the Form 10-K is not filed by the end of that sixteen month period. For a company with a calendar year fiscal period, this means the Form 10-K has to be filed by April 30, otherwise the Form S-8 is not useable thereafter. If, however, the Form 10-K is filed on May 15, the Form S-8
would again be useable without further action by the company.\textsuperscript{18} The filing of an Item 4.02 Form 8-K can lead to the conclusion that the company no longer has a valid prospectus under Section 10(a) of the Securities Act. The biggest fallout from an inability to use Form S-8 is that employee benefit plans have to shut down resulting in employee morale issues.

- Form S-3 availability – Assuming that the company is able to conclude that it has no concerns under Section 12(a)(2) of the Securities Act or under the antifraud provisions of the federal securities laws, you will be able to continue using Form S-3 until at least your next update under Section 10(a)(3) of the Securities Act of 1933, after which date your Form S-3 will have to be converted to a Form S-1. Although Form S-3 availability has traditionally focused on timely filing of Form 10-K to refresh the registration statement under Item 512 of Regulation S-K, the Staff’s position on Form S-8 with respect to the sixteen month period under Section 10(a)(3) of the Securities Act is applicable to Form S-3. Unlike Form S-8 which has a current reporting requirement as the trigger for eligibility, Form S-3’s requirement for timely reporting during the prior twelve months will cause the company to have to file a post-effective amendment to the Form S-3 to convert it to a Form S-1. Like the Form S-8 analysis, the filing of an Item 4.02 Form 8-K can mean that the company no longer has a valid prospectus under Section 10(a) of the Securities Act.

- Loss of WKSI status – If you did not file your Form 10-K on a timely basis or you did not meet the requirements of Section 10(a)(3) of the Securities Act with respect to

\textsuperscript{18} This assumes that the Form 10-K constitutes a valid prospectus under Section 10(a) of the Securities Act because of incorporation by reference.
the prospectus, you will have lost your status as a Well Known Seasoned Issuer and can only use Form S-1.

- Rule 144 under the Securities Act of 1933 is not available for sales of restricted securities or control securities because the current information requirement of Rule 144(c) is not being complied with.

- Section 211 of the Delaware General Corporation Law (“DGCL”) requires a company to hold an annual meeting even though it is unable to distribute an annual report to shareholders pursuant to Rule 14a-3 of the Securities Exchange Act of 1934 when shareholders use in Delaware Chancery Court to compel the company to hold a meeting.19 The rub for the company is that while it has to hold the annual meeting under Section 211, it can’t solicit proxies from shareholders for management’s slate of directors under the SEC’s proxy rules. Other corporate codes, such as Ohio, state provisions that have not been the subject of litigation. This can cause issues when hedge funds or others have bought the stock and are asking for a change of management and/or the sale of the company because of management’s performance as exemplified by the restatement and how long its taking to complete the process.

- It is not business as usual – since a restatement means that historical financial statements are no longer reliable, a company’s ability to secure financing, either public or private, to make acquisitions, using its own securities as currency and to conduct normal business operations is adversely affected.

- Hedge funds – acquiring the debt and following a Bearing Point approach or acquiring the common stock and running a proxy contest under Section 211 of the

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DGCL can cause a change of control and also can cause, or facilitate, a sale of the company to a third party.

- Employee morale – as demonstrated by the options dating situations, employees, especially in technology companies, depend on non-cash compensation and a restatement, especially one that takes a prolonged period to complete, can result in a decline in employee morale, as well as turnover, when employees leave to take jobs at companies that are current in their SEC filing obligations.

- Material contracts – anticipate deadlines and the requirements in your material contracts.

- Litigation – especially in situations where there has been a drop in the per share price of the stock or where the investigation with audit committee oversight conducted by independent counsel has found intentional wrongdoing by senior management over a sustained period of time. See Rule 7 below.

- Bankruptcy – although it seldom happens, a bankruptcy can result from a restatement that is not completed prior to the filing in bankruptcy court.

5. Be aware of the potentially divergent interests that can arise in a post-SOX world. These include the special responsibilities of members of the audit committee, certifications by the CEO and the CFO under Sections 302 and 906 of SOX, external auditor responsibilities, such as Section 10A of the Securities Exchange Act of 1934, and your external auditor’s aversion to risk as well as part 205 for attorneys. These interests run the gamut from macro-issues, such as duties under SOX and SRO listing, to micro-issues, such as the disclosure in a Form 12b-25 and whether you file a Form 8-K pursuant to Item 4.02(a) or 4.02(b). Understand that a micro issue can become a macro issue.
6. From a procedural standpoint, restatements fall into two categories: those that require a review or investigation possibly conducted by independent counsel with oversight by the audit committee of the board of directors; and those that don’t, such as a restatement as a result of discontinued operations. Don’t just look at what caused the original issue to arise. Follow the flags wherever they lead and be prepared to initiate an investigation or expand the scope of your investigation, if one has been undertaken. The goal is to restate once and not to restate a restatement. The market can lose faith in you, your venders and banks can become frightened resulting in an adverse cascading effect, if you have to restate a restatement.

7. Restatements are a process. You have a choice: you can manage the process or it can manage you. Approach it like any other project with a beginning, a middle and an end. “A classic project management process is very helpful to keep track of schedules and progress as well as facilitating the prompt identification of issues that need to be resolved.”\textsuperscript{20} The bigger the restatement, the more project managers you will need to keep track of the myriad of details, schedules and issues.

8. The audit committee has oversight responsibility, whether or not an investigation or review is being conducted. Therefore, coordination and transparency among and between management, the audit committee and the internal and outside auditors is critical. Anticipate issues by making sure your disclosure controls and procedures work now so that they will operate when put under the stress of a restatement. Involve the national office of your accounting firm especially if the restatement involves any judgment calls in applying GAAP. Have your outside law firm retain forensic

\textsuperscript{20} Bob Blakely, Chief Financial Officer of Federal National Mortgage Association (hereinafter “Bob Blakely”).
accountants so that SAB 99 memos can be prepared and reviewed before being furnished to the outside auditor.

9. Although the steps to analyze whether to restate are similar, every restatement is different. Expect the unexpected. Expect the restatement process to take longer than anyone thought it would and prepare core constituencies accordingly. Factors to consider in terms of timing include: the type and number of accounting issues; the number of periods involved; and how the restatement implicates internal control over financial reporting and prior certifications under Sections 302 and 906 of SOX. Even if internal control over financial reporting is not an issue at the beginning of the restatement process, it will become an issue before the process is completed. With increasing frequency, control deficiencies, particularly material weaknesses as defined in Public Company Accounting Oversight Board Auditing Standard No. 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” represent the “canary in the mineshaft” of financial reporting. A material weakness can foreshadow a restatement. If internal control over financial reporting becomes an issue during the restatement process, such as where systems are unable to provide reliable data, or personnel are no longer available to assist in preparing restated financial statements, or provide to management representatives, the outside auditor, the restatement process may take an extended period of time and you may not be able to estimate a completion date with any accuracy. While restatements may not always constitute a material weakness under the PCAOB’s proposed Audit Standard No. 5, which will replace AS 2, AS 5 has not yet been adopted.
10. Keep in mind that finalizing the restatement does not mean the job is finished. Among other things, there is the analysis of internal control over financial reporting, amendments to SEC periodic reports to be drafted, reviewed by all interested parties and filed. In multiple prior periodic reports will have to be amended as a result of the restatement, submit a waiver request to the Office of Chief Accountant of the Staff.\(^\text{21}\) Moreover, the SEC investigation will continue after the time the company has finished the restatement and regained its status as a current reporter at the SEC.

11. Restatements are expensive. An ounce of prevention is worth a pound of cure. Devoting the time, effort and expense now to have the right tone at the top, a fully staffed, talented and trained accounting staff and internal audit function, effective disclosure controls as well as internal controls and procedures can minimize the likelihood of a restatement.\(^\text{22}\) Otherwise, you will just be paying for the restatement and then incurring the same time, effort and expense to avoid the next one.

12. Remember that the biggest issue in restatements is not a legal, accounting, auditing or even a business issue – its psychological. A restatement is like a death in the family. A company is prone to going through the same stages of denial, blaming of others, self doubt and depression before coming to the realization that life has to go on and it’s important for everyone to get on with life. How fast a company goes through these stages and how quickly you recognize where you are in the process and how to cope with

\(^{21}\) The Dear CFO letter issued by the Division’s Office of Chief Accountant with respect to options dating restatements is attached as Appendix 3 to this paper.

\(^{22}\) Studies have shown that companies with good internal controls and thorough and effective IT audits have higher return on assets than those with material weaknesses. Terrence Belford “Information Technology Audits Catching on Fast” Globe & Mail BIO (April 16, 2007). Moreover, IT audits for internal control purposes can be broadened to include enterprise risk management and other business issues in addition to internal control over financial reporting. Id.
it and instill a culture of “can do” to replace a feeling of self-doubt is critical to completing the restatement process. Thus, the right attitude or the proper corporate culture can go a long way to getting the restatement completed correctly and quickly, rather than taking a long time and risking a restatement of a restatement.23

13. Once the restatement is completed, conduct a post mortem, but be careful not to overreact by replacing your external auditor. If you do change accountants, the new accounting firm can challenge past practices and policies that your former external auditor agreed to, which, in turn, may result in a further restatement. Thus the grass is not necessarily greener. This, is especially the case where you have not retained sufficient documentation to explain past decisions, such as judgment calls on the application of GAAP, or the personnel who made the decisions are no longer with the company. Unless the new auditor is provided with documentation, there is a risk that the new auditor won’t sign off on the current period where the same accounting policy is being applied because the new auditor could be concerned that the new client will be selected for review by the PCAOB inspector reviewing the audit firm and the lack of sufficient documentation will be a black mark against the new auditor. So adequate documentation can be useful both for purposes of accounting and internal control over financial reporting.

14. In appropriate circumstances, consider using Public Company Accounting Oversight Board Auditing Standard No. 4, “Reporting on Whether a Previously Reported Material

23 Coping mechanisms, include overcoming the negatives by sharing the positives, like celebrating milestones in the restatement process. “Staffs often become both extremely conservative and shell shocked when a restatement is required. Part of the psychology that must be reinforced is surfacing issues promptly so they can be resolved. Bad news doesn't age well. Also, don't be critical of mistakes or false starts. The issues are typically complex and if management is not 100% supportive, guess what? The issue doesn't get promptly raised the next time.” Bob Blakely.
Weakness Continues to Exist,” to have your outside auditor conduct an audit of material weaknesses disclosed in the Form 10-K with restated financial statements. Audit Standard No. 4 can help put the adverse effects of a restatement behind management before the next Section 404 audit by the outside auditor.
AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: The interpretations in this Staff Accounting Bulletin express the staff’s views regarding the process of quantifying financial statement misstatements. The staff is aware of diversity in practice. For example, certain registrants do not consider the effects of prior year errors on current year financial statements, thereby allowing improper assets or liabilities to remain unadjusted. While these errors may not be material if considered only in relation to the balance sheet, correcting the errors could be material to the current year income statement.

Certain registrants have proposed to the staff that allowing these errors to remain on the balance sheet as assets or liabilities in perpetuity is an appropriate application of generally accepted accounting principles. The staff believes that approach is not in the best interest of the users of financial statements. The interpretations in this Staff Accounting Bulletin are being issued to address diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet.

DATE: September 13, 2006.

FOR FURTHER INFORMATION CONTACT: Mark S. Mahar, Office of the Chief Accountant (202) 551-5300, Todd E. Hardiman, Division of Corporation Finance (202) 551-3400, or Toai P. Cheng (202) 551-6918, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission’s official approval. They represent interpretations and practices followed by the Division of Corporation Finance, the Division of Investment Management and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Nancy M. Morris
Secretary

Date: September 13, 2006
Part 211 – [AMEND]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 108 to the table found in Subpart B.

A. STAFF ACCOUNTING BULLETIN NO. 108

The staff hereby adds Section N to Topic 1, Financial Statements, of the Staff Accounting Bulletin Series. Section N provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment.

Note: The text of SAB 108 will not appear in the Code of Federal Regulations.

1. Topic 1: Financial Statements

* * * * *

2. N. Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (e.g., overstated liability) in the amount of $100, which has built up over 5 years, at $20 per year.¹ The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (i.e., years 1-4). For the purpose of evaluating materiality in the current year (i.e., year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Question 1: Has the registrant appropriately quantified the amount of this error for the purpose of evaluating materiality for the current year?

Interpretive Response: No. In this example, the registrant has only quantified the effects of the identified unadjusted error that arose in the current year income statement. The staff believes a registrant’s materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors.² This analysis generally begins with quantifying potential misstatements to be evaluated. There has been diversity in practice with respect to this initial step of a materiality analysis.

¹ For purposes of these facts, assume the registrant properly determined that the overstatement of the liability resulted from an error rather than a change in accounting estimate. See FASB Statement 154, Accounting Changes and Error Corrections, paragraph 2, for the distinction between an error and a change in accounting estimate.

² Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.
The diversity in approaches for quantifying the amount of misstatements primarily stems from the effects of misstatements that were not corrected at the end of the prior year (“prior year misstatements”). These prior year misstatements should be considered in quantifying misstatements in current year financial statements.

The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the “rollover” and “iron curtain” approaches.

The rollover approach, which is the approach used by the registrant in this example, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (i.e., it ignores the “carryover effects” of prior year misstatements).

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement’s year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a $100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by $100 with a corresponding decrease in current year expense.

As demonstrated in this example, the primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.

In contrast, the primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (i.e., the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the $80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the “correct” accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

The staff does not believe the exclusive reliance on either the rollover or iron curtain approach appropriately quantifies all misstatements that could be material to users of financial statements.

In describing the concept of materiality, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, indicates that materiality determinations are based on
whether “it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item” (emphasis added).  

The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant’s financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

As a reminder, a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.  

The staff believes that the registrant should quantify the current year misstatement in this example using both the iron curtain approach (i.e., $100) and the rollover approach (i.e., $20). Therefore, if the $100 misstatement is considered material to the financial statements, after all of the relevant quantitative and qualitative factors are considered, the registrant’s financial statements would need to be adjusted.

It is possible that correcting an error in the current year could materially misstate the current year’s income statement. For example, correcting the $100 misstatement in the current year will:

- Correct the $20 error originating in the current year;
- Correct the $80 balance sheet carryover error that originated in Years 1 through 4; but also
- Misstate the current year income statement by $80.

If the $80 understatement of current year expense is material to the current year, after all of the relevant quantitative and qualitative factors are considered, the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

The following example further illustrates the staff’s views on quantifying misstatements, including the consideration of the effects of prior year misstatements:

**Facts:** During the course of preparing annual financial statements, a registrant is evaluating the materiality of a sales cut-off error in which $50 of revenue from the following year was recorded in the current year, thereby overstating accounts receivable by $50 at the end of the current year. In addition, a similar sales cut-off error existed at the end of the prior year in which $110 of revenue from the current year was recorded in the prior year. As a result of the combination of the current year and prior year cut-off errors, revenues in the current year are understated by $60

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3 Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms - Materiality.
4 Statement 154, paragraph 2h.
($110 understatement of revenues at the beginning of the current year partially offset by a $50 overstatement of revenues at the end of the current year). The prior year error was evaluated in the prior year as being immaterial to those financial statements.

**Question 2:** How should the registrant quantify the misstatement in the current year financial statements?

**Interpretive Response:** The staff believes the registrant should quantify the current year misstatement in this example using both the iron curtain approach (i.e., $50) and the rollover approach (i.e., $60). Therefore, assuming a $60 misstatement is considered material to the financial statements, after all relevant quantitative and qualitative factors are considered, the registrant’s financial statements would need to be adjusted.

Further, in this example, recording an adjustment in the current year could alter the amount of the error affecting the current year financial statements. For instance:

- If only the $60 understatement of revenues were to be corrected in the current year, then the overstatement of current year end accounts receivable would increase to $110; or,
- If only the $50 overstatement of accounts receivable were to be corrected in the current year, then the understatement of current year revenues would increase to $110.

If the misstatement that exists after recording the adjustment in the current year financial statements is material (considering all relevant quantitative and qualitative factors), the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

If the cut-off error that existed in the prior year was not discovered until the current year, a separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated. If that analysis indicates that the prior year financial statements are materially misstated, they would need to be restated in accordance with Statement 154.5

**Facts:** When preparing its financial statements for years ending on or before November 15, 2006, a registrant quantified errors by using either the iron curtain approach or the rollover approach, but not both. Based on consideration of the guidance in this Staff Accounting Bulletin, the registrant concludes that errors existing in previously issued financial statements are material.

**Question 3:** Will the staff expect the registrant to restate prior period financial statements when first applying this guidance?

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5  Statement 154, paragraph 25.
Interpretive Response: The staff will not object if a registrant\(^6\) does not restate financial statements for fiscal years ending on or before November 15, 2006, if management properly applied its previous approach, either iron curtain or rollover, so long as all relevant qualitative factors were considered.

To provide full disclosure, registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year, and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

Early application of the guidance in Topic 1N is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, filed after the publication of this Staff Accounting Bulletin. In the event that the cumulative effect of application of the guidance in Topic 1N is first reported in an interim period other than the first interim period of the first fiscal year ending after November 15, 2006, previously filed interim reports need not be amended. However, comparative information presented in reports for interim periods of the first year subsequent to initial application should be adjusted to reflect the cumulative effect adjustment as of the beginning of the year of initial application. In addition, the disclosures of selected quarterly information required by Item 302 of Regulation S-K should reflect the adjusted results.

http://www.sec.gov/interp/account/sab108.htm

\(^6\) If a registrant’s initial registration statement is not effective on or before November 15, 2006, and the registrant’s prior year(s) financial statements are materially misstated based on consideration of the guidance in this Staff Accounting Bulletin, the prior year financial statements should be restated in accordance with Statement 154, paragraph 25. If a registrant’s initial registration statement is effective on or before November 15, 2006, the guidance in the interpretive response to Question 3 is applicable.
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 60
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THE BANK OF NEW YORK, not in its individual
capacity but solely in its capacity as Indenture Trustee on
behalf of all Holders of 2.75% Series B Convertible
Subordinated Debentures Due December 15, 2024 of
BearingPoint, Inc.,

Plaintiff, Index No. 600169/06

-against-

BEARINGPOINT, INC.,

Defendant.

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APPEARANCES:

For Plaintiff: For Defendant:

Kleinberg, Kaplan, Wolff & Cohen, P.C. LLP Fried, Frank, Harris, Shriver & Jacobson
551 Avenue of the Americas One New York Plaza
(David Parker, Edward P. Grosz, Esqs.) (Matthew Gluck, Esq.)

Anthony, Ostlund & Baer, P.A.
90 S. 7th Street, Ste. 3600
Minneapolis, MN 55402
(Jeffrey I. Ross, Esq.)

FRIED, J.:

Plaintiff The Bank of New York, not in its individual capacity but solely in its
capacity as Indenture Trustee on behalf of all Holders of 2.75% Series B Convertible
Subordinated Debentures Due December 15, 2024 of BearingPoint, Inc., moves, pursuant to
CPLR 3212, for an order granting summary judgment as to the first cause of action asserted in
the complaint.

Defendant BearingPoint, Inc. cross-moves, pursuant to CPLR 3212, for summary
judgment, dismissing the complaint.
Plaintiff The Bank of New York is a New York banking corporation with its principal place of business in New York, New York. The Bank of New York is the indenture Trustee (Indenture Trustee) under an indenture, dated as of December 22, 2004 (Indenture), between BearingPoint, Inc. (Bearingpoint) and itself as Trustee. Pursuant to the terms of the Indenture, BearingPoint issued $225 million principal amount of its 2.50% Series A Convertible Subordinated Debentures and $175 million principal amount of its 2.75% Series B Convertible Subordinated Debentures due December 15, 2024. The registered Holder of the Notes is Cede & Co., the nominee of the Depository Trust Company (DTC). Defendant BearingPoint is a publicly held global management and technology consulting firm that trades on the New York Stock Exchange. BearingPoint is incorporated under the laws of the State of Delaware, with its corporate headquarters in McLean, Virginia.

BearingPoint failed to file its required Annual Report on form 10-K for the December 31, 2004 year end, either with the SEC, with which it was due on or about March 16, 2005, or with the Indenture Trustee, with which it was due on or about April 1, 2005. BearingPoint also failed to file its required form 10-Q for the quarter ending March 31, 2005, either with the SEC, with which it was due on or about May 15, 2005, or with the Indenture Trustee, with which it was due on or about May 30, 2005. Furthermore, BearingPoint failed to file its required form 10-Q for the quarter ending June 30, 2005 either with the SEC, with which it was due on or about August 14, 2005, or with the Indenture Trustee, with which it was due on or about August 29, 2005.

The complaint alleges that BearingPoint’s failure to file with the Trustee copies of its annual and quarterly reports breached § 5.02 of the Indenture. In addition, plaintiff alleges that by failing to make the required filings with the SEC, BearingPoint was responsible for the
failure of a condition precedent to filing such annual and quarterly reports with the Indenture Trustee, as required by § 5.02 of the Indenture.

The complaint alleges that on or about September 8, 2005, BearingPoint was provided with a Notice of Default by Holders of the Series B Debentures, notifying BearingPoint of its failure to comply with § 5.02 of the Indenture, and that an Event of Default would occur if this failure continued for 60 days. More specifically, the letter stated:

As set forth in our letter dated August 26, 2006 (copy attached), we represent entities, which in the aggregate, own in excess of 25% of the Debentures issued by the Company pursuant to that certain Indenture dated, December 22, 2004 (the “Indenture”), by and between the Company and The Bank Of New York, as trustee. Insofar as BearingPoint, Inc. has failed to file with the SEC its form 10-K or Form 10-Q for the most recent reporting periods and has failed to provide the Trustee for this issue of securities with substantially the same information required to be contained in such filing, by this letter you are notified of a default under Sections 5.02 and 7.01 (g) of the Indenture. Pursuant to Section 7.01 of the Indenture, we hereby demand that the Company cure such default within sixty (60) days from the receipt of this Notice of Default.

This letter shall serve as a “Notice of Default” pursuant to Section 7.01 of the Indenture (Notice of Cross Motion, exhibit 6).

On or about November 17, 2005, in accordance with § 7.02 of the Indenture, BearingPoint was notified by holders of the Series B debentures that an Event of Default had occurred and was continuing and that, as a result, the principal amount of the Series B Debentures, the accrued and unpaid Interest, and any accrued and unpaid Liquidated Damages were due and payable immediately (the Notice of Acceleration). BearingPoint made no such payment to the holder of the Series B Debentures. Plaintiff alleges that as of the date of the filing of this complaint, BearingPoint still had not filed its 2004 10-K, or its first quarter and second quarter 2005 10-Qs with the SEC or with the Indenture Trustee and had not complied with the Notice of Acceleration.
In its first cause of action, plaintiff sues for breach of contract, alleging that, as the Indenture Trustee, it is entitled to relief since BearingPoint breached the Indenture. Plaintiff alleges that Holders of the Series B Debenture are entitled to the remedy of acceleration or, in the alternative, damages pursuant to § 7.03 of the Indenture, as well as all other appropriate relief, including an award of attorneys’ fees to the Indenture Trustee in accordance with the terms of the Indenture. In its second cause of action, plaintiff alleges that, to the extent that BearingPoint did not breach an express obligation set forth under § 5.02 of the Indenture, it breached an implied obligation, i.e., the covenant of good faith and fair dealing in the Indenture, and that Holders of the Series B Debentures are entitled to the remedy of acceleration or, in the alternative, damages pursuant to § 7.03 of the Indenture, as well as all other appropriate relief, including an award of attorneys’ fees to the Indenture Trustee in accordance with the terms of the Indenture.

BearingPoint cross-moves for summary judgment, pursuant to CPLR 3212, to dismiss the complaint. BearingPoint alleges that the notice of default sent by plaintiff’s law firm was deficient to provide notice of default to BearingPoint, pursuant to the notification procedures enunciated in the Indenture. BearingPoint further alleges that it did not violate any duties or obligations imposed by the Indenture and that, consequently, there was no defaulting event.

Section 5.02 of the Indenture, denominated “SEC and Other Reports,” provides, in pertinent part:

[T]he Company shall file with the Trustee, within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and of the information, documents and other reports (or copies of such portions of any of the foregoing the SEC may by rules and regulations prescribe) which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of TIA Section 314(a).

(Complaint, exhibit 3, at 46-47).
Thus, by reference, § 5.02 incorporates Section 13 of the Securities Exchange Act of 1934, which expressly provides that publicly held companies must file annual and quarterly reports with the SEC “as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security” (15 USC § 78m [a]). Furthermore, the requirement to provide the annual and quarterly reports to the Trustee is mandated by Section 314(a) of the Trust Indenture Act of 1939 (the TIA) (15 USC Ch 2A Subch III) which is expressly referenced in the above-quoted language. Indeed, § 5.02 of the Indenture essentially adopts the exact language of Section 314(a)(1) of the TIA, which obligates an issuer of bonds or notes to provide the Indenture Trustee with its quarterly and annual SEC reports (15 USC § 77nnn).

The Indenture defines a default as follows:

Section 7.01. Events and Defaults. So long as any Securities are outstanding, each of the following shall be, with respect to each series of Securities, an “Event of Default”

***

(g) The Company fails to comply with any of the terms, agreements or covenants of the Company in the Securities or this Indenture […] and such failure continues for 60 days after receipt by the Company of a Notice of Default

(Complaint, exhibit 3, at 49-50).

The Indenture’s acceleration clause states:

Section 7.02. Acceleration. If an Event of Default with respect to a series of Securities […] occurs and is continuing (the default not having been cured or waived), the Trustee by notice to the Company, or the Holders of at least 25% in aggregate principal amount of the Securities of such series at the time outstanding by notice to the Company and the Trustee, may declare the principal amount of such series of Securities and any accrued and unpaid Interest and accrued and unpaid Liquidated Damages, if any, on all the Securities through the date of acceleration of such series to be immediately due and payable. Upon such a declaration such accelerated amount shall be due and payable immediately

(Complaint, exhibit 13, at 52).
It is axiomatic that the movant for summary judgment must tender sufficient evidence to eliminate any material issue of fact from the case (see JMD Holding Corp. v. Congress Fin. Corp., 4 NY3d 373 [2005]; Alvarez v. Prospect Hosp., 68 NY2d 320 [1986]). The failure to make such a showing requires denial of the motion, regardless of the sufficiency of the opposing papers (Winegrad v. New York Univ. Med., Ctr., 64 NY2d 851 [1985]). Once this showing has been made, however, the burden shifts to the party opposing the motion for summary judgment to produce evidentiary proof in admissible form sufficient to establish the existence of material issues of fact which require a trial of the action. Mere conclusions, expressions of hope, or unsubstantiated allegations or assertions are insufficient for this purpose (Zuckerman v. City of New York, 49 NY2d 557 [1980]).

In support of its motion for summary judgment, plaintiff argues that § 5.02 required BearingPoint to provide the Indenture Trustee with SEC filings, which BearingPoint failed to do, thereby breaching that section of the Indenture. BearingPoint, on the other hand, contends that its obligation to furnish the Indenture Trustee with annual and quarterly reports was dependent upon its filing those reports with the SEC. BearingPoint urges that since it did not file with the SEC, it had no obligation to provide copies of the filings with the Indenture Trustee.

In support of its cross motion, BearingPoint argues that as a threshold matter, the September 9, 2005 Notice of Default sent by the Holders’ attorney was deficient for Tailoring to comply with the Notice of Default provisions of the Indenture. In support of this contention, defendant relies upon the terms of the Indenture, which, according to BearingPoint, would designate Cede, as DTC’s nominee, as the sole Holder of the Notes, since the Notes were issued as a single global security registered in Cede’s name (Indenture § 2.01, at 14). Plaintiff argues that Cede’s role, as registered Holder, is purely ministerial since Cede has no beneficial interest
in the Notes and has no authority to act except on behalf its participants (see Offering Memorandum, at 62, affidavit of Marc R. Rosen, exhibit A). Plaintiff also contends that BearingPoint’s argument that, notwithstanding Cede’s purely administrative role, only Cede, rather than the beneficial Holders, was capable of proffering the Notice of Default, is contradicted by the provisions of the Offering Memorandum of the Indenture.

The Offering Memorandum describes the Indenture and Notes. It uses the term “Holder” to refer to the beneficial Holder, as distinct from the registered Holder, as follows:

A holder may own its interest in the global Debentures directly through DTC if such holder is a participant in DTC, or indirectly through organizations which are direct DTC participants if such holder is not a participant in DTC .... Holders may also beneficially own interests in the global Debentures held by DTC through certain brokers, dealers, trust companies and other parties that clear through or maintain a custodial relationship with a direct DTC participant, either directly or indirectly

(Offering Memorandum, at 61, Affidavit of Marc R. Rosen, exhibit A).

In describing the various rights of the beneficial Holders, the Offering Memorandum states that “A holder that would like to convert Debenture into share...should contact its broker” (Offering Memorandum, at 48, Affidavit of Marc R. Rosen, exhibit A). Read in this context, beneficial Holders are then described as entitled to give the requisite Notice of Default.

The Notice of Default provisions of the Indenture reside in Section 7.01, which provides that a Notice of Default may be sent by the Trustee or by “the Holders of at least 25% in aggregate of the principal amount of the [Notes]” (Complaint, exhibit 3, at 51; affirmation of Matthew Gluck). The Indenture provides that notice can be given by an agent of a Holder in lieu of the Holder itself:

Any request, demand, authorization, direction, notice, consent, waiver or other action provided for by this Indenture to be given or taken by Holders may be embodied in and evidenced by one or more instruments of substantially similar tenor signed by such Holders in person or by an agent duly appointed in writing;
and [...] such action shall become effective when such instrument or instruments are delivered to the Trustee and [...], to the Company, as described in Section 13.02. Proof of execution of any such instrument or of a writing appointing any such agent shall be sufficient for any purpose of this Indenture and conclusive in favor of the Trustee and the company, if made in the manner provided in this Section

(Indenture § 1.04 [a]).

Thus, an agent “duly appointed” by a Holder may provide notice under § 7.01 of the Indenture. Moreover, the above-quoted language states that the notice “becomes effective at the time of delivery” to the Trustee and to BearingPoint in accordance with § 13.02, i.e., the Indenture’s general “Notice” section.

On September 9, 2005, the law firm of Andrews & Kurth LLP delivered a Notice of Default to BearingPoint on behalf of “entities which in the aggregate, own[ed] in excess of 25% of the [Notes]” (Affidavit of Richard Baumfield [Baumfield affidavit], exhibit 2; Complaint, exhibit 4). On that day, three groups of funds, Fore Research and Management LP, Linden Advisor LP and Whitebox Advisors LLC, had provided written authorization to Andrews & Kurth to send the Notice of Default (Baumfield affidavit, exhibits 3, 4 and 5; affidavit of Robert G. Lennon, exhibit 1; affidavit of Hareesh Paranjape, exhibit 1; affidavit of Dale Willenbring, exhibit 2). The three funds advised Andrews & Kurth of their individual holdings, which totaled $90,764 million, to wit: more than 25% of the Notes.

A few days later, on September 14, 2005, Andrews & Kurth communicated directly with BearingPoint by phone, offering to identify the Holders pursuant to a confidentiality agreement (Baumfield affidavit, ¶ 4). BearingPoint stated that it would get back to Andrew & Kurth regarding the issues discussed, but never did (Baumfield affidavit, ¶ 4).

Two months later, on November 17, 2005, the three Holders who authorized Andrews & Kurth to send the Notice of Default on their behalf, authorized different counsel to
send a Notice of Acceleration (affirmation of Edward Grosz, exhibit 6). BearingPoint does not challenge the sufficiency of the acceleration notice.

After reviewing the documents produced by defendant, I find that as a threshold matter, the September 9, 2005 Notice of Default sent by Andrews & Kurth was sufficient as a matter of law. BearingPoint’s argument that only the registered Holder of the Notes has authority to send a notice of default finds no support either in the Offering Memorandum, which provides that Beneficial Holders are themselves authorized to send the Notice of Default, or in the provisions in the Indenture itself Consistent with these provisions, after receiving the Notice of Default, BearingPoint’s counsel sought to ascertain the identities of the Beneficial Holders in whose behalf the Notice of Default was sent.

Section 7.01 of the Indenture, requiring Notice by 25% of the Holders, must be read in conjunction with § 1.04 (a) of the Indenture, which provides for notice to be given by “an agent duly appointed in writing.” Such notice became effective as of the date it was delivered to BearingPoint and to the Trustee (Section 1.04 [a]). The Holders appointed Andrews & Kurth as their agent in writing on September 9, and also informed Andrews & Kurth of their holdings (Baumfield affidavit ¶ 3-5, exhibits 3, 4, 5, 6, 7, 8). In opposition to BearingPoint’s cross motion, plaintiff submits the affidavit of Richard Baumfield, who states that prior to sending the September 9, 2005 letter, his firm “requested and received from each Holder written communications confirming and representing to us their ownership of the Notes and authorizing Andrews Kurth LLP to send (the September 9, 2005 letter) on their behalf (Baumfield Affidavit, exhibits 3-8). In consideration of the documents submitted by plaintiffs, I find that there was full compliance with the Notice provisions in the Indenture.

Having communicated with Andrews & Kurth seeking identification of the beneficial Holders before discussing a possible settlement, BearingPoint should not be heard at
this juncture to argue that the law firm was without authority to represent the Holders. Equitable estoppel arises when one party makes statements or engages in conduct which induces another to act to its detriment (Bender v. New York City Health and Hosps. Corp., 38 NY2d 662 [1976] [party equitably estopped from asserting improper notice defense when its counsel had been aware of allegedly defective notice before litigation but acted inconsistently with that knowledge]). Defendant never questioned whether the “entities” mentioned in the September 9, 2004 letter were the beneficial Holders of the Bonds. Neither did defendant ask to confirm the status of the Holders on whose behalf notice was given as registered Holders, which it knew could have been only DTC or its nominee, Cede & Co. On the contrary, defendant sought to confirm the identity and requisite percentage ownership of the beneficial Holders. BearingPoint is, therefore, estopped from now arguing that only Cede & Co. could give notice (see Friedman v. Airlift Intl., Inc., 44 AD2d 459, 461 [1st Dept 1974] [if beneficial ownership is indisputable, failure to proceed in name of nominee “is of no significance”). Notably, the filing by the beneficial Holders has now been retroactively ratified by the registered Holder (ratification letters by Cede & Co.; see Applestein v. The Province of Buenos Aires, 415 F3d 242 [2d Cir 2005]; Fontana v. Republic of Argentina, 415 F3d 238 [2d Cir 2005], where the Second Circuit held that an owner of a beneficial interest must receive authorization from the registered holder of the bond before it may sue, but that such authorization may be granted subsequent to the filing of a lawsuit).

BearingPoint also contends that it did not breach the Indenture when it failed to provide the Indenture Trustee with timely SEC filings, alleging that it had no independent obligation under the Indenture to make any SEC filing, at all. This argument ignores the clear import of § 5.02 of the Indenture and the TIA. Under BearingPoint’s interpretation of the relevant Indenture provision, BearingPoint’s obligation to provide information to the Trustee was
contingent on whether or not it chose to file with the SEC. Section 5.02, however, unambiguously obligates BearingPoint to make the required SEC filings and to provide copies of them to the Trustee. The provision, which is denominated “SEC and other Reports,” provides:

 “[The Company shall file with the Trustee...copies of its annual report and of the information, documents and other reports...which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act” (emphasis provided). BearingPoint’s tortured parsing of this provision to read the section as making SEC filings optional under the terms of the Indenture, vitiates the clear purpose of the Indenture to provide information to the investors so that they may protect their investment. This proposed construction would defy the clear intentions of the parties and does not comport with the straightforward and unambiguous intent of the provision.

BearingPoint’s obligation to provide the Trustee with timely annual and quarterly reports is also expressly provided for by the second sentence of § 5.02 of the Indenture, which states: “The Company shall comply with the other provisions of TIA Section 314(a).” Section 314(a) of the TIA specifically obligates an issuer of bonds or notes, such as BearingPoint, to provide the Indenture Trustee with current SEC filings. Section 302(a)(4) of the TIA expressly provides that:

[T]he national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected …

(4) when the obligor is not obligated to furnish to the trustee under the indenture and to such investors adequate current information as to its financial condition, and as to the performance of its obligations with respect to the securities outstanding under such indenture ...

(15 USC § 77bbb [b]).

To implement Section 302, TIA § 314(a) expressly mandates that:
Each person who ... is or is to be an obligor upon the indenture securities covered thereby shall --

(1) file with the indenture trustee copies of the annual reports and of the information, documents and other reports...which such obligor is required to file with the Commission pursuant to section 78m or 780(d) of this title ...

(15 USC § 77nnn [a]).

Thus, § 5.02 requires BearingPoint to provide the Indenture Trustee with copies of required SEC filings, which BearingPoint failed to do. It is apparent that the underlying purpose of § 5.02 of the Indenture was to make BearingPoint’s financial information available to the Series B Debenture Holders by providing such information to the Trustee. As a memorialization of apparent commercial realities, this section expressed that which is known to the investment community, i.e. that only by guarding against incomplete information, can investors make informed decisions about their investment and guard against the risks attendant to incomplete information.

Although BearingPoint cites the Offering Memorandum in support of its position that it had no obligation to file SEC reports pursuant to the terms of the Indenture, the referenced provisions of the Offering Memorandum, which, in any event would only be considered upon finding of ambiguity in the indenture (Matter of Wallace v. 600 Partners Co., 86 NY2d 543, 548 [1995]) merely refer to the timing of the SEC filings and in no way obviate BearingPoint’s obligation to file with the SEC. On the contrary, the offering plan provides that:

[I]f we do not have audited financial statement available by March 31, 2005, we will be in default under our 2004 Credit Facility (unless the delay is solely as a result of continuing work by us and/or our independent registered public accounting firm to prepare opinions or statements required or permitted by Section 404 of Sarbanes-Oxley, in which case the requirement will be extended by 30 days) and possible other agreement. A default would permit the lender under the 2004 Credit Facility to terminate the 2004 Credit Facility, accelerate any outstanding loans and proceed against their collateral

(Cross-Motion, exhibit 4, at 12-13).
Thus, the clear and unambiguous import of the Indenture is merely underscored by the language in the Offering Memorandum.

In the absence of ambiguity which obscures the intentions of the parties to a contract, the interpretation of a contract and the obligations of the parties thereto are questions of law and not of fact (R/S Assoc. v. New York Job Dev. Auth., 98 NY2d 29, 32 [2002]; Bethlehem Steel Co. v. Turner Constr. Co., 2 NY2d 456 [1957]). “[W]hen parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms” (W.W.W. Assoc. v. Gianconti, 77 NY2d 157, 162 [1990]). It is well settled that “extrinsic and parol evidence is not admissible to create an ambiguity in a written agreement which is complete and clear and unambiguous upon its face” (Intercontinental Planning Ltd. v. Daystrom, Inc., 24 NY2d 372, 379 [1969]. Having found that the terms of § 5.02 are unambiguous, Bearingpoint’s attempts to modify the terms of the provisions of the Indenture by referring to the Offering Memorandum are unavailing.

Since BearingPoint argues that there was no obligation to file reports with the SEC under the Indenture, they argue that the inexorable conclusion is that there was no Default Event. On the contrary, by not filing required SEC reports, BearingPoint repudiated its obligations under the Indenture, thereby frustrating the Trustee’s rights under the Indenture. A party’s repudiation of its future obligations under a contract may take the form of “a voluntary affirmative act which renders the obligor unable or apparently unable to perform without such a breach” (Norcon Power Partners v. Niagara Mohawk Power Corp., 92 NY2d 458, 463 [1998]). BearingPoint cannot take advantage of its failure to fulfill its obligation to file timely reports with the SEC by arguing that it has consequently not breached its obligation to provide the Trustee with copies of such reports (see In re Bankers Trust Co., 450 F3d 121 [2d Cir NY 2006]).
Consequently, the Notice of Default sent in the September letter was sufficient, and BearingPoint’s cross-motion for summary judgment is unfounded in evidentiary proof sufficient to dismiss the complaint. Furthermore, plaintiff has established as a matter of law that BearingPoint defaulted under the provisions of § 5.02. Since the default mechanisms of the Indenture were fully satisfied by the September 9, 2005 Default letter and the November 17, 2005 Acceleration letter, BearingPoint was obligated to accelerate immediately all principal and accrued interest. Having failed to do so, BearingPoint breached § 7.02 of the Indenture (Complaint, exhibit 1, first cause of action, ¶ 21).

Accordingly, it is hereby

ORDERED that defendant’s cross motion for summary judgment to dismiss the complaint is denied; and it is further

ORDERED that plaintiff’s motion for summary judgment on its first cause of action is granted, and defendants found liable for breach of contract with the amount of damages to be determined at trial; and it is further

ORDERED that the remainder of the action shall continue.

Dated: 9/18/06

ENTER:

__________________________
J.S.C.
BERNARD J. FRIED
J.S.C.
APPENDIX 3 to Rules of the Road for Restatements

SAMPLE LETTER SENT IN RESPONSE TO INQUIRIES RELATED TO FILING RESTATED FINANCIAL STATEMENTS FOR ERRORS IN ACCOUNTING FOR STOCK OPTION GRANTS

In December 2006, the Division of Corporation Finance responded to inquiries from several public companies requesting filing guidance as they prepare to restate previously issued financial statements for errors in accounting for stock option grants. The following illustrative letter provides information for registrants to consider as they prepare reports to be filed with the Commission to correct errors in accounting for stock option grants.

January 2007

Name
Chief Financial Officer
XYZ Corporation
Address

Dear Chief Financial Officer:

We understand that you plan to restate previously issued financial statements for errors in your accounting for grants of stock options to employees, members of the board of directors, and other service providers and that you have determined that your periodic filings for multiple periods contain materially inaccurate financial statements and related disclosures. In this letter, we are providing you with guidance as you consider how you will address these deficiencies in your periodic filings. You should not interpret this guidance to mean that we will not review your filings if you follow it. Furthermore, as with all staff guidance, the Commission has not approved this letter or the guidance we provide in it.

The Securities Exchange Act of 1934 requires you and your company to file reports with the Commission and to determine the accuracy and adequacy of the information you provide in them. Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. However, since the restatement for errors in accounting for grants of stock options will affect a significant number of years, you have indicated that your company would be unduly burdened by amending all previously filed reports and that the filing of those numerous amendments could adversely impact the ability of a reader of your financial statements to easily and fully understand the impact of the restatement.
The staff of the Division of Corporation Finance will not raise further comment regarding your company’s need to amend prior Exchange Act filings to restate financial statements and related MD&A if your company amends its most recent Form 10-K and includes in that amendment the comprehensive disclosure outlined below. If your next Form 10-K is due to be filed within two weeks of the Form 10-K amendment that you would file in response to this guidance, we will not comment on your company’s need to amend or file prior Exchange Act filings to restate financial statements and related MD&A if your company includes the comprehensive disclosure outlined below in that next Form 10-K, rather than including the comprehensive disclosure in an amendment to your most recent Form 10-K.

In taking this position, we understand that you will include the following disclosure in your Form 10-K amendment (or your next Form 10-K, as appropriate):

- An explanatory note at the beginning of the Form 10-K amendment that discusses the reason for the amendment.

- Selected Financial Data for the most recent five years as required by Item 301 of Regulation S-K, restated as necessary and with columns labeled “restated”.

- Management’s Discussion and Analysis as required by Item 303 of Regulation S-K, based on the restated annual and quarterly financial information, explaining the company’s operating results, trends, and liquidity during each interim and annual period presented. Discussions relative to interim periods may be incorporated into the annual-period discussions or presented separately.

- Audited annual financial statements for the most recent three years, restated as necessary and with columns labeled “restated”.

- If interim period information for the most recent two fiscal years as required by Item 302 of Regulation S-K is required to be restated, the information presented for the balance sheets and statements of income should be in a level of detail consistent with Regulation S-X Article 10-01 (a)(2) and (3), and appropriate portions of 10-01(b) and with columns labeled “restated”. Note that there is no need to present cash flow information as it is not required by Item 302.

- Footnote disclosure reconciling previously filed annual and quarterly financial information to the restated financial information, on a line-by-line basis and for each material type of error separately, within and for the periods presented in the financial statements (audited), in selected financial data, and in the interim period information (see paragraph 26 of FASB Statement No. 154).

- The disclosure referred to in the Chief Accountant’s September 19, 2006 letter that applies to your restatement (the letter can be found at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).

- Audited financial statement footnote disclosure of the nature and amount of each material type of error separately that is included in the cumulative adjustment to opening retained earnings.
• Audited financial statement footnote disclosure of the restated stock compensation cost in the following manner:

  o For the most recent three years: restated net income and compensation cost and pro forma disclosures, required by paragraph 45.c. of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as clarified and amended by FASB Statement No. 148, for each annual period presented in the financial statements for which the intrinsic value method of accounting in APB Opinion 25 was used, with columns labeled “restated” as appropriate.

  o For each annual period preceding the most recent three years: disclosure of the information required by paragraph 45.c.2. of FASB Statement No. 123, the restated stock compensation cost that should have been reported for each fiscal year. The total of the restated stock-based compensation cost should be reconciled to the disclosure of the cumulative adjustment to opening retained earnings. While the disclosure required by paragraph 45.c.2. is net of tax, material tax adjustments related to the accounting for stock-based compensation should also be disclosed by year. Registrants may also elect to voluntarily provide the full restated information previously disclosed pursuant to paragraph 45.c. of FASB Statement No. 123, for each period prior to the most recent three years, either in the audited financial statement footnotes or elsewhere in the filing.

  o For companies that adopted (1) FASB Statement No. 123 using the retroactive restatement method specified in FASB Statement No. 148 and/or (2) FASB Statement No. 123R, *Accounting for Share-Based Payment*, using the modified retrospective application method for all prior years for which FASB Statement No. 123 was effective: the disclosure outlined in the preceding two paragraphs should include the restated stock-based compensation pursuant to FASB Statement No. 123 and also the restated stock-based compensation cost that should have been reported under the accounting principle originally used for each period, presumably Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.

• Appropriate revisions, if necessary, to previous disclosure under Items 9A and 9B:

  o As we discussed in “Staff Statement on Management’s Report on Internal Control Over Financial Reporting” (May 16, 2005) (available at http://www.sec.gov/spotlight/soxcomp.htm), in disclosing any material weaknesses that were identified as a result of the restatement and/or investigation, you should consider including in your disclosures: the nature of the material weaknesses, the impact on the financial reporting and the control environment, and management’s current plans, if any, for remediating the weakness. While there is no requirement for management to reassess or revise its original conclusion of the effectiveness of internal control over financial reporting, management should consider whether its original disclosures are still appropriate and should supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading.
In light of the restatement and new facts discovered by management, including identification of any material weaknesses, disclose the certifying officers’ conclusion regarding the effectiveness of the company’s disclosure controls and procedures as of the end of the period covered by the amended filing. If the certifying officers’ conclusion remains the same, that disclosure controls and procedures are effective, you should consider discussing the basis for that conclusion.

In advising you that the staff of the Division of Corporation Finance will not raise further comment regarding your company’s need to amend prior Exchange Act filings to restate financial statements and related MD&A, it is important that we advise you that this guidance does not:

- mean the Division of Corporation Finance will not comment on or require changes in your Form 10-K amendment or Form 10-K that includes the comprehensive disclosure we outlined above;
- mean the Division of Corporation Finance has concluded that you or your company have complied with all applicable financial statement requirements;
- mean the Division of Corporation Finance has concluded that the company has satisfied all rule and form eligibility standards under the Securities Act and the Exchange Act;
- mean that the Division of Corporation Finance has concluded that the company is current in filing its Exchange Act reports;
- mean that the Division of Corporation Finance has concluded that the company has complied with the reporting requirements of the Exchange Act;
- foreclose any action recommended by the Division of Enforcement with respect to your disclosure, filings or failures to file under the Exchange Act; or
- foreclose any action recommended by the Division of Enforcement under Section 304 of the Sarbanes-Oxley Act, *Forfeiture of Certain Bonuses and Profits*, with respect to the periods that the company’s financial statements require restatement, irrespective of whether the company amended the filings to include the restated financial statements.

As you know, the staff of the Office of the Chief Accountant is continuing to consider matters related to the accounting for stock options (we refer you again to Conrad Hewitt’s September 19th letter at [http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm](http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm)). If you would like to discuss the particular facts and circumstances of your stock option grants and the accounting conclusions you have reached, we encourage you to contact Joe Ucuzoglu, Professional Accounting Fellow in the Office of the Chief Accountant at 202-551-5301 or Mark Barrysmith, Professional Accounting Fellow in the Office of the Chief Accountant 202-551-5304.

We have provided this guidance to you based on our understanding of your circumstances surrounding your decision to restate your financial statements to correct errors related to your
accounting for stock options. Materially different circumstances, including filing delinquencies and restatements for other reasons, could result in our reaching a different conclusion.

Please direct any questions about the guidance we have provided to you in this letter to the staff of the Chief Accountant’s Office in the Division of Corporation Finance (202-551-3400).

Sincerely,

Carol A. Stacey
Chief Accountant
Division of Corporation Finance

http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm