CLASS ACTION SETTLEMENTS
FINANCIAL AND TAX REPORTING

by Peter Robbins, CPA

Special acknowledgement to **CHRIS HESSE**, **STEVE BODINE**, and **PAUL PARKER**, all partners at CliftonLarsonAllen, LLP, for their significant review and input. Their technical advice and editing have been invaluable.

Even the best of intentions can sometimes result in bad consequences and when actions are motivated by less than honorable purposes, or worse, laced with greed, negligence, or just ignorance, the consequences can be dire. A simple internet search on class action lawsuits provides ample evidence that in our litigious society the consumer watchdogs and advocates for "doing the right thing" are vigilant and looking for opportunities to make corporations and their executives pay for the consequences of poor decisions.

This article presents a discussion of current financial accounting, disclosure regulations, and tax consequences of claims-made class action settlements. The impact of a class action settlement can be devastating for a company not just in terms of the potential financial settlement costs and related expenses, but also in terms of degradation to the financial statements. In addition, the article will present a new insurance alternative that allows defendants in class actions to cover the claims risk involved with the settlement funds. Using this new form of insurance, the company can "lock in" the costs of the settlement by effectively transferring the take rate risk to an insurance carrier, thereby achieving certainty and mitigating the negative impact of the settlement on its financial statements.

CURRENT FINANCIAL ACCOUNTING RULES AND REGULATIONS

Class action settlements typically have a maximum payout established by the parties and approved by the court. Once the settlement is approved, the process can take months or even years for the settlement to become final and the claims process to be completed. All the while, the settling company has to carry the liability for the full amount of the claims-made settlement fund on its books. Additionally, the actual claim rate can vary dramatically thereby creating uncertainty as to the actual financial cost of the settlement which can wreak havoc on a company's liquidity and financial planning.

The Financial Accounting Standards Board (FASB) promulgates the accounting regulations for financial reporting and, specific to this article, the regulations for class action contingencies. Financial accounting of contingencies is governed by Accounting Standards Codification Topic 450 (ASC 450)[1] which states that a Company's estimated loss from a contingency shall be accrued on the Company's financial statements by a charge to income if:

a) information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and

b) the amount of the loss can be reasonably estimated.[2]

As established by the Financial Accounting Standards Board, Generally Accepted Accounting Principles (GAAP) mandates that a company is required to disclose any asset impairment or liability incurrence that is considered to be "probable".[3] Since a class action settlement agreement creates a known and probable liability, GAAP requires that the Company book the entire settlement and assumes 100% "take rate"[4] participation in order to provide legal and financial transparency to the public regarding the claim.[5] Thus, when a Company settles a class action lawsuit and establishes a claims-made process, it has two choices: (1) take a charge on its financial statements for the entire amount of the settlement, thereby possibly devastating its financial position to shareholders and others, or (2) purchase insurance thereby capping its maximum net liability to the amount of the insurance premium.

Even in the event that the contingent loss cannot be easily estimated or the loss contingency is only "reasonably possible" (i.e., less than likely but more than remote), GAAP requires that a company must still disclose the nature of the contingency.[6] "Disclosure" of the loss contingency generally involves the "nature of the contingency" and, to the extent known, an estimate of the possible loss (or a statement that an estimate cannot be made).[7] In addition, the disclosure should also include the basis of the claim, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the Company in similar cases, and any decision of the Company's management as to how the enterprise intends to respond to the lawsuit (e.g., defend vigorously) or assessment.[8] Thus, as consequence of the ASC 450 regulations, a Company is generally obligated to provide substantial information regarding a class action settlement and how it originated. The company can be adversely impacted by both the description of the underlying facts giving rise to the class litigation as well as the GAAP charges for fully booking the settlement on the financial statements. Note that this obligation to report litigation applies to both public and private companies. Further, because a settlement may continue for months or even years, the liability and disclosure requirement can linger. A company may find itself in a position where the negative impact of the settlement must be disclosed over numerous quarters or years.

In addition to the reporting requirements of ASC 450, the United States Securities and Exchange Commission (SEC) also mandates reporting requirements on Form 8-K, requiring that a company disclose class action settlements if such settlement is classified as a "material definitive agreement." The definition of "material definitive agreement" includes an agreement that provides for obligations that are material to and enforceable against the Company. A company must disclose the following information upon entry into, or material amendment of, a material definitive agreement:

a) The date on which the agreement was entered into or amended, the identity of the parties to the agreement and a brief description of any material relationship between the company or its affiliates and any of the parties, other than in respect of the material definitive agreement or amendment; and

b) A brief description of the terms and conditions of the agreement or amendment that are material to the company.[9]

Generally, the filing of Form 8-K must be done within four (4) business days after the occurrence of the "event" (i.e., the class action settlement that triggers the filing of the form). In addition, the filing of Form 8-K may constitute the first "public announcement" for purposes of Rule 165 under the Securities Act of 1933.[10] Also note, a Form 8-K filing mandates that the Company's next quarterly report must include a disclosure of the material definitive agreement, which will include the full amount of the class action settlement fund.

The nature of disclosure must be carefully considered by the company. As previously discussed, the requirements of ASC 450 mandate that certain loss contingencies must be disclosed in financial statements regardless of whether the loss is determined to be probable or reasonably possible. For example, assume Company X is forced with "probable" loss contingencies in the form of a $250 million class action settlement; this amount must be reported as an accrued liability. Furthermore, Company X must provide a detailed explanation of the nature of the claim, the process, and other important aspects of the contingency (including how it will be funded). These important aspects may include relevant names, issues, or components of the litigation. On Company X's next financial statement, investors will be able to ascertain the fact that a potential $250 million liability is an obligation of the Company, and be able to review as well supplemental information regarding the claim. In addition, Company X will be required to continue filing SEC and financial statement reports regarding the status of the claims and any other aspects of the underlying litigation. It should also be noted that failing to properly disclose a contingency in compliance with ASC 450 is classified as "financially unrepresentative" under Sarbanes-Oxley Act of 2002, and could cause criminal charges to Company management.[11]

Even if the loss is deemed to be "reasonably possible," footnote disclosures must be included in the company's financial statements thereby notifying the financial statement reader of the potential for loss and economic drain on the company. In either case, the class action settlement will have a significant detrimental impact on the company's financial statements.

TAX TREATMENT OF CLASS ACTION SETTLEMENTS

Considering the proliferation of litigation in today's business world, it would seem reasonable that all the costs associated with settling lawsuits would be considered an "ordinary and necessary" business expense and thus deductible under §162 of the Internal Revenue Code. However, every experienced tax professional knows that the Code is rife with exceptions and restrictions that can trap the unwary. Consequently, given the magnitude of most class action settlements, the wise tax professional will examine the facts carefully to determine appropriate tax treatment for class action settlements.

Section 162 provides, in part, that all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on trade or business may be deducted. Like most IRC rules, there are numerous exceptions to this general rule.[12] In order to determine whether the payments to class members may be tax deductible, settling parties must consider the implications of IRC §162(c)(2) and §162(f) which prohibit deductions for payments deemed to be illegal under U.S. or state law and payments for any fine or similar penalty paid to a government for the violation of any law, respectively. Applying IRC §162(f), in *Allied-Signal Inc. v. Com.*,[13] the Third Circuit, affirming the Tax Court, ruled that a statutory penalty is not tax deductible even if the government does not actually "pocket" or receive the penalty. In *Allied-Signal*, the company was not allowed to deduct an $8 million contribution to an environmental fund since the payment reduced the criminal fine that would otherwise have been assessed for the underlying conduct. The IRS ruled that the payment was punitive in nature and because it was made at the direction of a district judge deemed it to have been "paid to a government."

"... every experienced tax professional knows that the Code is rife with exceptions and restrictions that can trap the unwary."

In Technical Advice Memorandum 200502041, the IRS ruled that while a portion of a lump sum payment representing a remedial measure intended as compensatory damages was deductible, the portion of the payment which represented a fine or penalty was nondeductible. The IRS utilized the provisions of IRC §162(f) in holding that the nondeductible portion of the payment was punitive in nature.

The origin of the claim doctrine requires that the character of a particular expenditure is determined by the underlying transaction from which the event proximately resulted. In Private Letter Ruling 200649011, the IRS – applying the origin of the claim doctrine – held that "the purpose, consequences, or result of the expenditure is relevant in determining the origin of the claim, and therefore, the character of the litigation cost for tax purposes." An examination of all the facts and circumstances is necessary to determine the proper tax treatment of the settlement costs. Further, it is possible that settlement payouts in a single class action lawsuit could relate to both ordinary business transactions[14] and capital transactions, and thus be required to be bifurcated into a deductible portion and a portion for which no tax benefit will ever be realized.

"…if the settlement and payment represents a fine or statutory penalty, then the payments are likely not tax deductible."

Applying the origin of the claim reasoning, settling companies must carefully consider whether and to what extent the class action settlement and related expenses are tax deductible. In *Anchor Coupling Co. v. U.S.*,[15] the court disallowed a deduction for settlement of a suit for specific performance of an agreement to sell assets. The court ruled that the origin of the suit involved the sale of capital assets and consequently must be capitalized. Likewise, in *Wellpoint Inc f/k/a Anthem Inc.*[16] the court held that because the origin of the claim was a dispute over title to capital assets, the settlement was not deductible.

In *Talley Industries Inc. v. Comm.*,[17] a case that ping-ponged back and forth between the Tax Court and Ninth Circuit Court, the central issue was whether the settlement was penal in nature which would prohibit the company from taking a tax deduction. The Courts did in fact come to this conclusion. The Courts were unpersuaded by how the settlement was classified or labeled in the settlement documents but rather reached the conclusion that the payment represented double damages under the False Claims Act and was consequently a nondeductible payment regardless as to what the parties tried to call it.

Talley Industries is just one of a multitude of cases where the IRS disallowed the deduction for settlements of lawsuits. Each class action settlement must be evaluated separately to determine the proper tax return treatment based upon a review of the underlying transaction. As per the ruling in TAM 200502041, companies may be required to allocate settlement payments and the accompanying tax treatment between deductible and nondeductible payments.

In summary, based upon the Code, interpretative rulings, and case law, settling parties need to be aware that not all class action settlements will result in tax deductible payments to class members. The deductibility of class action settlement costs is dependent on tracing the origin of the claims asserted in cause of the class action lawsuit back to the source of the litigation and the origin and character of the claim and nature of the ultimate payment. To the extent the litigation arose from acts that can be construed to have been conducted in the ordinary conduct of the taxpayer's business, a current tax deduction is warranted. In contrast, if the settlement and payment represents a fine or statutory penalty, then the payments are likely not tax deductible. Further, to the extent the litigation arose from a capital transaction such as the acquisition of an asset or in a claim relating to ownership rights to a capital asset, Section 263(a) requires capitalization of class action settlement payouts and related costs.[18] If capitalized, the deduction of settlement costs may be required to be spread over a number of years or the deduction may be disallowed entirely. This second scenario is problematic in that the settlement creates the degradation to the financial statements with no corresponding tax benefit.

THE NIGHTMARE SCENARIO

Let's go back to Company X which was involved in a $250 million class action settlement. We discussed that this amount must be reported as an accrued liability and that Company X must provide detailed disclosure of the claim which will alert the readers to the liability. Ongoing, quarterly disclosure will also be necessary and the current financial statements for Company X will show a charge to income of $250 million. Management of Company X may attempt to spin the settlement in a positive light, but it will most likely be difficult to convince investors that a $250 million loss is anything but a significant loss that harms not only the company's economic position, but also the investor's individual investment in the company. Additionally, attempts to minimize or mitigate the real economic impact of the settlement may set up the company for potential shareholder derivative and securities fraud lawsuits.

Worse still, if the claim is found to have arisen from a capital transaction or is punitive in nature the loss may not be

deductible on the tax return further harming the company's financial position. Even if the claim is deemed to be deductible, the company is further exposed to scrutiny by the IRS and potentially the necessity of defending the tax position.

INSURANCE: THE RISK TRANSFER ALTERNATIVE

A company that is entering into a claims made settlement of a class action lawsuit has only two paths it can take when booking the settlement and preparing its tax return. First, it can adhere to current ASC 450, Form 8-K and other disclosure requirements and take a GAAP charge for the full amount of the claims made settlement fund and review the facts and circumstances of the settlement to determine the proper tax filing position. This approach can cause shareholders (both present and prospective) to impugn the Company's financial stability, which directly influences its capital reserves and operations. In addition, the tax consequence either further harms the company or opens an avenue for IRS scrutiny. In the alternative, the company can insure the class action settlement which will effectively transfer the settlement liability from the company to the insurer. The purchase of an insurance policy for a specific class action case can help minimize the economic, tax, and investor disapproval exposure and result in more benign financial disclosure as the net liability is represented by the paid and incurred insurance premium.

The specific accounting treatment of the settlement and the insurance touch on numerous provisions under GAAP and must be evaluated on a case by case basis. Generally, with respect to the financial reporting requirements under ASC 720, insured entities recognize a liability for the probable losses from incurred but not reported claims and incidents if the loss is both probable and reasonably estimable.[19] There is not a general rule that would eliminate the liability even with insurance in place unless certain requirements have been met.[20] Once the insurance is in place, a company would normally continue to present the liability on its balance sheet, but also report an insurance receivable for claims that the insurance contract will pay. The practical effect of this accounting treatment is that the settlement liability is balanced against the insurance asset thereby mitigating the ultimate financial impact of the claims made settlement fund. Assuming the insurance covers 100% of the expected loss contingency; the balance sheet will contain both an asset and a liability in the same amount. The net impact on the income statement would be a charge for the cost of the insurance only rather than the charge for the entire amount of the claims made settlement fund.

Directly offsetting prepaid insurance and receivables for expected recoveries from insurers against a recognized incurred but not reported liability or a liability incurred as a result of a past insurable event is not appropriate.[21] While at first blush it would seem that the liability and insurance receivable could offset and simply be eliminated from the statement, the fact that the liability has not been extinguished or legally released requires that the reader of the financial statements be made aware of the potential continuing obligation of the company in the event that the insurer is unwilling or unable to honor the insurance contract. While possibly not directly on point with a company's particular circumstances, accounting guidance in specific industry arenas reinforces these general rules. For example, the health care specific standards provide that "the ultimate costs of malpractice claims or similar contingent liabilities, which include costs associated with litigating or settling claims, shall be accrued when the incidents that give rise to the claims occur. The liability shall not be presented net of anticipated insurance recoveries. An entity that is indemnified for these liabilities shall recognize an insurance receivable at the same time that it recognizes the liability, measured on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts."[22]

While insurance can be effectively used to eliminate or mitigate the GAAP charges arising out of the settlement, it is also a critical tool for tax purposes. Companies can face class actions arising out of both federal and state statutory schemes including but not limited to the Telephone Consumer Protection Act (TCPA), the Video Privacy Protection Act (VPPA), and the Fair and Accurate Credit Transactions Act (FACTA). These laws provide for statutory or punitive damages for violations. For this reason, many courts have taken the position that liability for the underlying conduct is not insurable. In *Standard Mutual Ins. Co. v. Lay*[23], the Fourth Circuit held that the statutory damages assessed under TCPA cannot be covered by insurance as a matter of public policy as they were punitive or penal in nature. While the court did not specifically rule on the tax deductibility of the damages for federal or state tax purposes, the IRS would likely reject a tax deduction for the payments to class members on the grounds that they are in fact penal in nature under the origin of the claim. Logically, the same reasoning that renders the conduct uninsurable also prevents the company from deducting the payments to class members.

Assuming appropriate insurance coverage is in place, the next question is whether the insurance premium for class action settlement insurance coverage is tax deductible. As noted above, a company can deduct ordinary and necessary business expenses under IRC §162. Further, there is no prohibition or limitation on the purchase of class action settlement insurance under IRC §264. Under the terms of class action settlement insurance products currently being offered in the marketplace, policies provide indemnity benefits for the take rate of the underlying settlement. As a result, companies do not risk the loss of coverage since the policy is covering the take rate and not the underlying act which gave rise to the settlement. Likewise, under this type of class action settlement insurance, the premium should be tax deductible as it is not a payment for a statutory penalty or punitive damages per se, but rather the ordinary and necessary cost of indemnity insurance and risk transfer for claims made under the settlement agreement.[24]

Once again returning to Company X, assume the company does not want to take a charge for its $250 million contingency of a class action settlement fund or suffer the full negative impact of the settlement on its balance sheet. The repercussions associated with the GAAP charges and disclosures may result in a default on debt covenants, downgrade of the company's debt rating, a substantial loss of investor capital or equity and an uncertain cost of the ultimate settlement that the company is not able or willing to absorb. Depending on the nature of the case, Company X may be able to insure the contingent liability in a manner that, if structured properly, would cover the claim, and in exchange for a fixed premium effectively transfer the contingent liability from Company X's books to the insurer. The key is for the insurance policy to create a GAAP qualified risk transfer that covers the entire claim period and the full value of the settlement fund.

Assuming such a policy is in place, Company X can mitigate the negative impact of the settlement on its financial statements via the booking of the insurance receivable, or in some cases only reporting the fact that it has an insurance policy to cover the class action settlement. In either case, the Company's net charge to income would only be the cost of the insurance rather than the entire settlement judgment.

By illustration, if Company X can obtain a tax deductible class action settlement insurance premium at a cost of $50M,[25] the effective after tax charge to earnings is actually (assuming a 35% corporate tax rate) $32.5 million. For most companies being able to obtain finality, certainty, and full tax deductibility is a far more preferable choice than taking a $250 million charge to the company's books during the pendency of the settlement claims process and bearing the full impact of the take rate risk.

In summary, a company faced with a class action settlement must accept the variability of the class action suit and GAAP charges on its financial statements, or obtain class action settlement insurance coverage thereby limiting the company's exposure by fixing its loss to the amount of the insurance premium. Companies need to weigh carefully the financial and investor impact of the charge against earnings, the ultimate take rate risk, the issue of tax deductibility, and the certainty and finality of the insurance alternative in order to determine whether the purchase of insurance will provide the best option to mitigate the financial and tax impact of the class action settlement liability.

ENDNOTES

1. ASC 450 was formerly Statement of Financial Accounting Standard No. 5 before the FASB Accounting Standard Codification project that was finalized in 2009.
2. ASC 450-20-25-2.
3. ASB, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies(1975), paragraph 3.
4. Take rate is the percentage of the class who files claims seeking the available benefit.
5. ricewaterhouseCoopers, Forensic Accounting Technical Notes: SFAS 5, "Accounting for Contingencies" (http://10b5.pwc.com/public/technical_case_notes.aspx).
6. ASC 450-20-50.
7. FASB, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (1975), paragraph 10.
8. PricewaterhouseCoopers, Forensic Accounting Technical Notes: SFAS 5, "Accounting for Contingencies" (http://10b5.pwc.com/public/technical_case_notes.aspx).
9. SEC Form 8-K, Section 1, Item 1.01.
10. SEC Form 8-K, General Instructions, Section A.
11. Sarbanes-Oxley Act of 2002, Sections 302 and 906.
12. Some exceptions to the general tax deductible rule include but are not limited to: Section 263(a)(1) disallows any current deduction for amounts paid for new buildings or for permanent improvements or betterments made to increase the value of property. In addition, Reg. §1.263(a)-4(c)(1) provides that amounts paid to another party to acquire any intangible from a third party in a purchase or similar transaction must be capitalized. These intangibles include an ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity. Additionally, amounts paid to facilitate the acquisition of an intangible also are not currently deductible but must be capitalized.
13. Allied-Signal Inc v. Com., (1995, CA3) 75 AFTR 2d 95-1287, 54 F3d 767, 95-1 USTC ¶50151, affg (1992) TC Memo 1992-204, RIA TC Memo ¶92204, 63 CCH TCM 2672.
14. In Private Letter Ruling 200911002, the IRS reviewed a securities fraud class settlement arising out of alleged misstatements of the company's financial condition. All the costs related to this class action settlement were deductible because the improper preparation of financial statements which were incorporated into previously filed SEC reports were deemed to be ordinary and routine business activities of a company. Therefore, the expenditures were deductible.
15. Anchor Coupling Co v. U.S., (1970, CA7) 25 AFTR 2d 70-1282, 427 F2d 429, 70-1 USTC ¶9431, revg (1969, DC IL) 23 AFTR 2d 69-1407m, 69-1 USTC ¶9347, cert den (1971, S Ct) 401 US 908, 27 L Ed 2d 806.
16. Wellpoint Inc f/k/a Anthem Inc, (2008) TC Memo 2008-236, RIA TC Memo ¶2008-236, 96 CCH TCM 260, affd(2010, CA7) 105 AFTR 2d 2010-1508.
17. Tally Industries Inc., et. al., TC Memo 1999-200 [1999 RIA TC Memo ¶99,200], RIA TC Memo ¶99200, 77 CCH TCM 2191 [1999 RIA TC Memo ¶99,200], on remand from (1997, CA9) 79 AFTR 2d 97-3096, 116 F3d 382, 97-1 USTC ¶50486, reversing and remanding (1994) TC Memo 1994-608 [1994 RIA TC Memo ¶94,608], RIA TC Memo ¶94608, 68 CCH TCM 1412 [1994 RIA TC Memo ¶94,608], affirmed.
18. In Private Letter Ruling 200649011, a publicly-traded corporation was a party to class action securities lawsuit involving misstatement of the company's reported earnings. The IRS determined that business expenses are not converted into capital expenditures solely because they have some connection to a capital transaction. Rather, it is necessary to look to the "origin of the claim" doctrine.
19. ASC 720-20-25-14.
20. It is possible, however, that the liability can be completely eliminated from the financial statements in certain situations. In order for the liability to be "derecognized" it must be extinguished by one of two means. First, the debtor can pay the creditor in full settlement of the obligation. Alternatively, the debtor can be legally released from being the primary obligor under the liability, either judicially or by the creditor. ASC 405-20-40-1. These stringent rules on derecognition must be carefully considered by the company and the outside auditors in determining the appropriate accounting treatment for class action settlement and the related insurance coverage.
21. ASC 720-20-45-1.
22. ASC 954-450-25-2.
23. Standard Mutual Ins. Co. v. Lay, 2012 IL App (4th) 110527.
24. Tax advice can only be given based upon full engagement and review of all relevant facts and circumstances. This is intended as a general rule but the specific facts and circumstances must be fully reviewed and analyzed to determine appropriate tax treatment.
25. This is an amount that is for illustration purposes only. The actual amount of premiums would be developed by the insurer after analysis of the actual claim and settlement options.

ABOUT THE AUTHOR

PETER ROBBINS became a partner with CliftonLarsonAllen, LLP (CLA) in November 2011 when his predecessor firm Middleton, Burns & Davis (MBD) merged into CLA. Peter was a shareholder of MBD and had been with that firm since January 1998. Previously he spent seven years with Ernst & Young LLP in Milwaukee, Wisconsin and four years with Grant Thornton LLP in Dallas, Texas.

Peter works closely with individuals, executives, and business owners providing tax compliance and consulting services, representation before the IRS, estate planning, consultation on stock option and other compensation issues, and general business planning. In addition, Peter works extensively in the trust and estate arena and with all forms of business enterprises including corporations, S corporations, partnerships, and limited liability companies.

Peter was an adjunct instructor at Southern Methodist University for eight years and has served as a guest lecturer and instructor for many professional organizations, including the American Institute of CPAs, Dallas Estate Planning Council and Boise Estate Planning Council. He has been published in several periodicals including *Independent Banker* and *Texas Independent Banker*. In addition, he is the author of the bi-weekly tax and accounting question and answer column, "Talking Tax", which is published in the *Idaho Business Review*.

Peter earned a Master in Science in Accounting degree from the University of Wisconsin-Oshkosh. Previously he earned Bachelor and Master degrees from Arizona State University.

Peter is a member of the American Institute of CPAs, the Texas Society of CPAs, the Idaho Society of CPAs, and the Boise and Treasure Valley Estate Planning Councils, as well as the Rotary Club of Southwest Boise.

CONTACT INFO
Peter Robbins, CPA
Partner with CliftonLarsonAllen, LLP.
(208) 387-6412
peter.robbins@cliftonlarsonallen.com