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SOX 302
Certifications:
What Are They
Good For?

Agency actions still rely heavily on pre-existing securities laws and rules.

BY ROBERT J.A. ZITO

AS A RESULT of the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or SOX), any quarterly or annual report filed by a U.S. public company with the U.S. Securities and Exchange Commission (SEC or the commission) must include the personal certification of the chief executive officer (CEO) and chief financial officer (CFO) under SOX 302. These certifications, along with the requirement to issue an internal control report, are universally reviled by senior management at public companies, especially smaller public companies that have limited wherewithal for regulatory rigmarole.

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Many have criticized Sarbanes-Oxley as an overreaching, expensive and hasty reaction to the corporate scandals of Enron, Tyco and WorldCom. A niche industry has emerged for accountants, lawyers and consultants who worship at the SOX altar and who capitalize on the fears of CEOs and CFOs that these certifications will be misused by class action lawyers if financial disclosures turn out to be technically inaccurate.

Companies and their CEOs and CFOs look to insure against their risk by seeking refuge in so-called "back-up" or "subcertifications" from lower level officers and employees to support the certifications of the CEO and CFO. Each year since the enactment of Sarbanes-Oxley, these certifications and subcertifications become progressively detailed and complex. But the question remains: What good are they?

As will be seen, CEOs and CFOs can find some comfort in the present litigation trends. Various stockholders have commenced class action suits unsuccessfully seeking to use inaccurate SOX 302 certifications as the basis to support the scienter requirement under §10 of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5, and the special pleading requirements under the Private

Securities Litigation Reform Act of 1995 (PSLRA). Moreover, while strict liability is implied under SOX 302, a review of the SEC enforcement actions brought during the last five years reveals that, absent some underlying fraudulent activity or significant accounting irregularity, the commission is disinclined to pursue violations under SOX 302.

Requirements and Penalties

Section 302 of Sarbanes-Oxley¹ requires the CEO and CFO to personally certify that the officer has reviewed the report and determined, based on his knowledge, that: (i) the report does not contain any untrue statement and (ii) the financial information in the report fairly presents the financial condition, results of operation and cash flows of the company. In addition, the CEO and CFO must certify that their company has designed "disclosure controls and procedures" and a system of "internal control over financial reporting" sufficient to support their belief that the report and financial information are accurate and complete.

The CEO and CFO must also certify that they evaluated the effectiveness of the company's "disclosure controls and procedures" and must provide their conclusions about the effectiveness of the procedures in each report. As a result, the CEO and CFO must take responsibility for the disclosure in the company's periodic reports, making it difficult for them to disclaim knowledge of the company's disclosure.

The application of certifications under SOX 302 and Rule 13a-14(a) (under §13(a) of the Exchange Act) is limited to CEOs and CFOs.² That is to say, these provisions are inapplicable to lower level employees who provide "back-up" or "subcertifications" to CEOs and CFOs. SOX 304 limits the commission's disgorgement remedies to events that involve an "accounting restatement." Inaccurate certifications that violate SOX 302, §13(a) of the Exchange Act and Rule 13a-14 thereunder could be used to demonstrate the "unfitness" of the offending officer and could result in a bar against that officer from acting as an officer or director of a public company under SOX 305 and 1105.³ Further, SOX 906(a) and (b) requires CEOs and CFOs to certify (i) that

the report fully complies with §13(a) or 15(d) under the Exchange Act and (ii) the report fairly presents the financial condition and the results of operations of the company. SOX 906(c) provides for criminal sanctions for knowing violations of SOX 906(a) or (b).

The commission's rules adopted under Sarbanes-Oxley also separately require each public company to maintain "disclosure

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controls and procedures"⁴ and "internal control over financial reporting."⁵

SEC Enforcement Actions

Prior to the enactment of Sarbanes-Oxley, federal law and SEC rules required public companies to file accurate reports, disclose material information to shareholders and fairly present the company's financial information. Sarbanes-Oxley changed the law to specifically require that CEOs and CFOs become personally involved in the company's process for capturing material information.

The cases thus far brought by the SEC staff for violations of SOX 302, and in turn, §13(a) of the Exchange Act and Rule 13a-14, involve some underlying fraud or significant accounting irregularities, as opposed to some minor deviation from GAAP or a misstatement that does not result in a restatement of financials. Apparently, the commission does not have an interest in pursuing technically inaccurate certifications under SOX 302.

Typically, the SEC asserts that the certifying officers provided false certifications in addition to violating numerous other provisions of the federal securities laws. In other words, there is an underlying fraud alleged, and the SOX violations are just

piled on. See, e.g., Complaint, *Sec. and Exch. Comm'n v. Reyes*, No. C-06-4435 (N.D. Cal. July 20, 2006), 2006 WL 2066488 (alleging that former CEO/president/chairman of Brocade Communications Systems, Inc. and its former vice president of human resources backdated stock option grants, and the former CFO was aware of the backdating); Complaint, *Sec. and Exch. Comm'n v. Mercury Interactive, LLC*, No. C-06-4435 (N.D. Cal. May 31, 2007), 2007 WL 1654872 (alleging that CEO, CFO and general counsel backdated options); Complaint, *Sec. and Exch. Comm'n v. Alexander*, No. 06-CV-3844 (EDNY Aug. 8, 2006), 2006 WL 2699523 (alleging that former chairman/CEO, former CFO and former general counsel backdated options); Complaint, *Sec. and Exch. Comm'n v. Kamber*, No. 1:07-cv-01867 (D. D.C. Oct. 16, 2007) (alleging that former CEO, former controller and former group vice president fraudulently inflated the company's income by manipulating reserves and refusing to recognize expenses and liabilities).

Inference of 'Scienter'

The U.S. Court of Appeals for the Fifth and Eleventh Circuits recently issued decisions which rejected the argument that a §302 certification alone was sufficient to establish a strong inference of scienter under the PSLRA.

In *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006), the plaintiffs filed a securities class action against NDC Health Corp. (NDC), several of its officers and its auditor for violating §§10(b) and 20(a) under the Exchange Act. The plaintiffs alleged that NDC violated GAAP, misstated the value of a failed investment and engaged in "channel stuffing," a practice whereby a company floods distribution channels by employing incentives to induce customers into purchasing products in large quantities, creating a short-term bump in revenue and excess supply in the distribution chain. The district court dismissed the complaint because the plaintiffs failed to adequately plead scienter under the requirements of the PSLRA. The plaintiff appealed the decision arguing that Sarbanes-Oxley certifications were "indicia of [d]efendants' scienter."

The Eleventh Circuit held that Sarbanes-

Oxley evidences no intent to alter the pleading requirements of the PSLRA, and the Sarbanes-Oxley certifications are only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements. The court recognized that adopting the plaintiffs' interpretation of Sarbanes-Oxley would establish scienter in every case where there was an accounting error or auditing mistake made by a public company and would eviscerate the pleading requirements set forth in the PSLRA. Severe recklessness would be established if "the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions." The Eleventh Circuit affirmed the dismissal of plaintiffs' complaint.

In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*, 497 F.3d 546 (5th Cir. 2007), the plaintiff shareholder brought a securities class action against Integrated Electrical Services (IES), its CEO and two men who served as its CFO at different times, alleging that IES and certain of its officers made public false and misleading statements concerning the company's financial condition, in violation of §§10(b) and 20(a) of the Exchange Act and Rule 10b-5. The district court held that the plaintiff's complaint failed to state with particularity facts giving rise to a strong inference of scienter. The plaintiff appealed, among other grounds, that defendants' §302 certification was indicative of scienter. The Fifth Circuit applied the U.S. Supreme Court's recent decision in *Tellabs v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), which clarified the plaintiff's requirement under the PSLRA to plead facts giving rise to a strong inference of scienter. The Supreme Court held that a complaint will survive a motion to dismiss "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."

The Fifth Circuit rejected the plaintiff's argument that scienter could be inferred on the basis of the Sarbanes-Oxley certifications standing alone. The court accepted *Garfield*,

as a plausible interpretation of the Sarbanes-Oxley Act. As discussed above, *Garfield* held that a Sarbanes-Oxley certification is indicative of scienter only if the person signing the certification had reason to know, or should have suspected, due to accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions. The Fifth Circuit refused to infer scienter from the Sarbanes-Oxley certifications because the plaintiff did not clearly explain the link between the statements about the internal controls and IES's actual accounting problems. The Fifth Circuit upheld the trial court's dismissal of the complaint.

A number of federal district courts have also analyzed whether a §302 certification could be used to prove scienter. In a few of these cases, the plaintiffs have successfully avoided dismissal in district court. See, e.g., *In re Lattice Semiconductor Corp. Sec. Litig.*, 2006 WL 538756 (D. Or. Jan. 3, 2006) (denying motion to dismiss complaint and holding that the Sarbanes-Oxley certifications combined with plaintiffs' other allegations were sufficient to create a strong inference of scienter); *In re Am. Italian Pasta Co. Sec. Litig.*, 2006 WL 1715168 (W.D. Mo. June 19, 2006) (denying motion to dismiss in part and granting motion to dismiss in part).

Many of the district court cases have dismissed the plaintiffs' complaints and are generally consistent with the Fifth and Eleventh circuits in holding that allegations of false and misleading §302 certifications do not solely give rise to a strong inference of scienter. See, e.g., *In re BearingPoint, Inc. Sec. Litig.*, 2007 WL 2713906 (E.D. Va. Sept. 12, 2007) (granting motion to dismiss); *Comwmc'n Workers of Am. Plan for Employees' Pensions & Death Benefits v. CSK Auto Corp.*, 2007 WL 951968 (D. Ariz. March 28, 2007) (granting motion to dismiss); *In re Watchguard Sec. Litig.*, 2006 WL 2927663 (W.D. Wash. Oct. 12, 2006) (granting motion to dismiss plaintiff's amended complaint); *Ley v. Visteon*, 2006 WL 2559795 (E.D. Mich. Aug. 31, 2006) (granting motion to dismiss); *In re Hypercom Corp. Sec. Litig.*, 2006 WL 1836181 (D. Ariz. July 5, 2006) (granting motion to dismiss). Nonetheless, plaintiffs continue to assert that the Sarbanes-Oxley certifications support

their claim that the certifying officers acted with scienter. See, e.g., Consolidated Second Amended Class Action Complaint, *In re Take-Two Interactive Sec. Litig.*, 1:06-cv-00803-SWK (SDNY April 16, 2007).

One of the first district court decisions addressing the impact of Sarbanes-Oxley certifications in securities' cases, *In re Watchguard Sec. Litig.*, 2006 WL 2038656 (W.D. Wash. April 21, 2006), provides a thoughtful discussion regarding whether Sarbanes-Oxley certifications are actionable. In *Watchguard*, the plaintiffs alleged that the certifying officers falsely inflated revenue and then certified the inflated numbers in order to become eligible for bonuses which were contingent on the company meeting certain financial goals.

The court dismissed the plaintiffs' complaint holding that the Sarbanes-Oxley certifications alone are insufficient to support a strong inference of scienter. In its decision, the court recognized the plaintiffs' argument that Congress enacted Sarbanes-Oxley to prevent certifying officers from invoking a "head-in-the-sand" defense to allegations brought under Rule 10b-5. The court noted that although Sarbanes-Oxley makes it somewhat more reasonable to infer that a certifying officer whose head is in the sand is being deliberately reckless, "it does not transform the PSLRA requirement of falsity-plus-scienter into a requirement of falsity-plus-Sarbanes-Oxley-certification." The court stated, "[b]ecause the PSLRA places the burden on Plaintiffs to plead facts giving rise to a 'strong inference' that a defendant's head was above the sand, or was at least deliberately recklessly buried in the sand, its defendant-friendly provisions trump the plaintiff-friendly Sarbanes-Oxley Act, at least in this case."

The Use of Subcertifications

SOX 302, §13(a) of the Exchange Act and Rule 13a-14 thereunder do not require a company to require employees who are not CEOs or CFOs to make any certification regarding the financial condition of the company. Rather, subcertifications are the creature of attorneys, accountants and consultants. Subcertifications are designed to support SOX 302 certifications and to protect CEOs and CFOs who are required to

certify under SOX 302. Such subcertifications also form a part of the internal control and disclosure control requirements under various provisions of Sarbanes-Oxley. To the extent that such subcertifications are not signed by CEOs and CFOs, such cannot be the basis for a violation under SOX 302. If certifications cannot be used to fulfill the scienter requirement for violations under §10 of the Exchange Act, neither can subcertifications.

Research reveals that the SEC has not brought any cases using an inaccurate subcertification as the basis for a violation under SOX 302. *Sec. and Exch. Comm'n v. Tenet Healthcare Corp.*, No. 07-2144 (C.D. Cal. April 2, 2007), involves subcertifications. Under the allegations of that case, the senior executives of Tenet Healthcare Corp. jointly engaged in a scheme to take advantage of an accounting loophole in the Medicare reimbursement system relating to outlier payments, which are supplemental payments to hospitals for the treatment of extraordinarily sick Medicare patients, in order to meet its earnings target. Tenet's gross revenues increased by 118 percent even though its actual costs only increased by 16.5 percent.

Tenet failed to disclose publicly its outlier revenue strategy until an industry analyst report hypothesized that its financial success had been driven by a significant increase in Medicare outlier payments, which the company ultimately admitted. As a result, Tenet's stock dropped approximately 50 percent, representing an \$11.3 billion market capitalization loss. In addition, Tenet's reserves were improperly treated on its financial statements and were not in reported accordance with GAAP. Tenet ultimately restated its Form 10-K and 10Q filings during the relevant period. Tenet's co-presidents, chief financial officer, chief accounting officer, chief operating officer and general counsel were each charged with, among other things, violations under §10 of the Exchange Act and Rule 10b-5 thereunder and aiding and abetting violations of §13(a) of the Exchange Act and Rule 13a-14 thereunder.

Each of the defendants received bonuses that were tied, at least in part, to the company's

earnings. One of the defendants executed the Form 10-Ks and 10-Qs. While each of the defendants executed company subcertifications, each was, far more importantly, primarily responsible for the preparation of financial reporting for the company.

Tenet entered into a consent judgment, without admitting or denying the allegations, that enjoined it from violating the securities laws and that required it to pay a civil penalty of \$10 million. Some of the other defendants settled their cases by being subject to the identical injunction and by paying a civil penalty.

The subcertifications in *Tenet* were beside the point. The scheme alleged in *Tenet* was a basic "cooking the books" securities fraud involving chief executives who knowingly conspired to improperly pump up the income of a company in order to enhance their financial remuneration. The alleged scheme was a classic fraud under §10 of the Exchange Act and Rule 10b-5 thereunder. The aiding and abetting violations of §13(a) of the Exchange Act and Rule 13a-14 added nothing. Even without the enactment of Sarbanes-Oxley, the defendants would have been charged with violations of securities fraud under §10 of the Exchange Act. The Sarbanes-Oxley violations should be viewed as mere piling on.

Conclusions

The recent case law suggests that CEOs and CFOs are not doomed—even if a financial mistake is discovered and reported by their company. The commission does not appear at the moment to be interested in playing "gotcha" by bringing enforcement actions for violations of SOX 302, unless the violation results in a significant, but not necessarily a material, misstatement of the company's financial statements. The courts are almost uniformly holding that a mere inaccurate certification, without more, does not meet the scienter pleading requirements under the PSLRA.

Nor does the commission appear to be interested in making the case through enforcement proceedings that "back-up" certifications or subcertifications are either required under SOX 302, or can be the basis for a SOX 302 violation. What remains to

be seen, however, is to what extent "back-up" certifications are useful at all, especially if the forms are complex and broadly and legalistically worded. Subcertifications are useful, in part, to demonstrate that adequate controls are in place, as required under various provisions of Sarbanes-Oxley. However, it is doubtful that a company, or its CEO and CFO, would be able to skirt liability resulting from a restatement of financial statements under SOX 302 simply because subcertifications of lower level employees were relied upon.

Finally, if Sarbanes-Oxley was intended, at least in part, to require companies to set up internal controls and to have senior executives take ownership of financial reporting through the execution of certifications in order to prevent financial misreporting, it failed miserably in *Tenet*. None of the officer certifications and subcertifications and other Sarbanes-Oxley procedures in place prevented Tenet's executive officers from allegedly cooking Tenet's books.

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1. Section 302 of Sarbanes-Oxley requires the SEC to adopt rules requiring the principal executive and financial officers (or persons performing similar functions) to provide certifications to their periodic reports. The SEC implemented the certification requirements of §302 of Sarbanes-Oxley by adopting Rules 13a-14 and 15d-14 under §§13 and 15 of the Exchange Act, respectively in response to §302 of Sarbanes-Oxley. See 17 CFR §240.13a-14(a); 17 CFR §240.15d-14(a).

2. Rule 13a-14(a) under the Exchange Act which implements §302 of Sarbanes-Oxley requires "[e]ach principal executive officer and principal financial officer of the issuer, or persons performing similar functions, at the time of the filing of the report" to sign a certification. 17 CFR §240.13a-14(a).

3. Prior to the enactment of Sarbanes-Oxley, the prerequisite to obtaining an officer and director bar was "substantial unfitness."

4. "Disclosure controls and procedures" are generally controls and other procedures designed to ensure that the information required in a company's filings is recorded, processed, summarized and reported on a timely basis. These procedures must be designed to ensure that required disclosure is communicated to the company's management, including the CEO and CFO, to allow timely decisions regarding required disclosure. 17 CFR §240.13a-15(e).

5. "Internal control over financial reporting" refers to a company's accounting and financial reporting controls and includes policies and procedures that: (i) pertain to the maintenance of records that accurately, fairly, and in reasonable detail reflect transactions and dispositions of assets; (ii) provide reasonable assurance that transactions are recorded so as to permit preparation of financial statements in accordance with GAAP and that receipts and expenditures are made only in accordance with management authorization; and (iii) reasonable assurance regarding prevention and detection of unauthorized acquisition, use or disposition of the company's assets. 17 CFR §240.13a-15(f).

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