SECURITIES LITIGATION

Litigation Implications of the CEO and CFO Certification Requirements of the Sarbanes-Oxley Act

The new CEO and CFO certification requirements in Sections 302 and 906 of the Sarbanes-Oxley Act and the SEC's implementing rules have raised questions as to the potential increased liability faced by these executive officers. As a result companies are considering such issues as documentation, "back up" certifications and privilege.

by Richard A. Rosen and Daniel J. Kramer

Much ink has been spilled explicating the novel CEO/CFO certification requirements imposed by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). But what are the real-world litigation implications of these requirements? Are they genuinely likely to increase litigation risk for senior officers? Will they make it harder for defendants to win at the motion to dismiss stage? What are some of the practical litigation issues raised by efforts that companies will be making to comply with the new requirements?

Statute and Proposed Implementing Regulations

As is well known by now, on August 29, 2002, pursuant to Section 302 of the Sarbanes-Oxley Act, the SEC issued rules under the Securities Exchange Act of 1934 (Exchange Act) imposing new certification requirements.[1] The new rules mandate:

- CEO/CFO certifications as to the contents of each annual and quarterly report, as to "disclosure controls and procedures" (a new concept related to disclosure) and as to "internal controls" (an existing concept relating to financial reporting, certain elements of which are viewed by the SEC as a subset of "disclosure controls and procedures");
- Establishment and maintenance of "disclosure controls and procedures;"
- Evaluation prior to the filing of each annual or quarterly report of such "disclosure controls and procedures;" and
- Disclosure in each annual and quarterly report concerning the effectiveness of such procedures, based on the mandated evaluation, and any changes in "internal controls."

The new rules apply to all SEC-reporting companies, both domestic and foreign. For US companies, certification of reports are required for filings of annual reports on Form 10-K and to quarterly reports on Form 10-Q, as well as for amendments to these. Certification is *not* required for current reports on Form 8-K (though the new rules require that disclosure controls and procedures be designed, maintained and evaluated to ensure full and timely disclosure in such reports).

For purposes of analyzing whether the certification requirements magnify litigation risk, Section 302's requirements can be usefully separated into two major categories: (1) certification of the truthfulness of accuracy of the contents of financial reports and (2) certification of the effectiveness and composition of internal and disclosure controls.

As to the first category, Section 302 requires every public company's CEO and CFO to certify that

- He or she has reviewed the covered report;
- Based on his or her knowledge, the report does not contain any untrue statement of a material

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fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report; and

- Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report.

As to the second category, Section 302 refers to both "disclosure controls" and "internal controls." "Disclosure controls and procedures" are defined as those controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized, and reported.

The August SEC Release states that each quarterly and annual report must contain a certification by the CEO and CFO that they:

1. Are responsible for establishing and maintaining "disclosure controls and procedures" for the issuer;
2. Have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
3. Have evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report;
4. Have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date;
5. Have disclosed to auditors and the audit committee:
   - all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
   - any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
6. Have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

At the same time, the SEC also adopted new Item 307 of Regulation S-K to require disclosure (in the company's annual and quarterly reports) about the principal officers' evaluation of the company's disclosure controls and procedures and whether or not there have been significant changes to the company's internal controls.

As for the internal controls, if pending SEC proposals are adopted,[2] annual and quarterly reports would

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contain additional certifications that the certifying officers:

1. Are responsible for establishing and maintaining internal controls and procedures for financial reporting;
2. Have designed (or caused to be designed) internal controls and procedures for financial reporting to provide reasonable assurances that the registrant's financial statements are fairly presented in conformity with generally accepted accounting principles;
3. Have evaluated the effectiveness of the company's internal controls and procedures for financial reporting as of the end of the period covered by the report;
4. Have presented in the report their conclusions about the effectiveness of the company's internal controls and procedures for financial reporting; and
5. Have identified any material weaknesses in the design or operation of the company's internal controls and procedures for financial reporting to the company's auditors and audit committee.

The SEC has proposed modifications to the certifications to make clear that the certifying officers need not personally *design* either disclosure controls and procedures or internal controls and procedures. Rather, the procedures may be designed by others, provided the certifying officers have "*supervised*" the design of such procedures.

Individual Liability Under Section 302

Prior to Sarbanes-Oxley, the CFO of a public company was already required to sign Form 10-Q and 10-K reports; the CEO was required to sign Form 10-Ks. CEOs and CFOs, therefore, were already subject to liability for securities fraud if they knowingly or recklessly signed financial reports that were proven to contain false information.[3] CEOs and CFOs are almost invariably named as individual defendants in the prototypical securities fraud class action by virtue of public statements that can be attributed to them, including, of course, statements contained in the financial disclosure documents they are required to sign. Thus, except insofar as the CEO is now certifying 10-Qs, the two senior officers are not making new personal statements about the accuracy of the financials; the risk that a securities fraud class action will name them as individual defendants for statements on this subject attributable to them does not, at first blush, change significantly after Sarbanes-Oxley.

By contrast, Sarbanes-Oxley does impose an obligation on the CEO and CFO to make a *new* series of affirmative statements about the efficacy of disclosure controls and internal controls of the issuer. In any case in which the issuer has been required to restate its financials (and doubtless in many other factual contexts in which the company materially disappoints investor expectations), it is virtually inevitable that plaintiffs will allege that the CEO's and CFO's statements about disclosure controls and internal controls were false and misleading, because, for example, the internal controls and procedures for financial reporting were *not* capable of providing reasonable assurance that the financials conformed to GAAP. To this extent, undoubtedly, the new statutory requirements expand the array of statements for which individuals are likely to be sued.

Pleading Scienter in Connection with Inaccurate Section 302 Certifications

Any plaintiff who wants to get to first base in a suit alleging that a Section 302 certification was false and misleading in violation of Rule 10b-5 is going to have to plead scienter. Although we have seen it suggested that the certification requirement would make it easier for plaintiffs to clear this pleading hurdle, we think that this is unduly alarmist. Application of well-settled principles should support the conclusion that Section 302 certifications have no bearing on the adequacy of scienter allegations.

Courts in all the circuits to address the issue, including those that accept the more relaxed pleading

Coming Attractions

- **Shelf registration issues**
- **Director Liability: recent decisions**
- **New accounting and disclosure requirements for guarantees**

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standard of "motive and opportunity," have held that various sorts of factual allegations that could be leveled against every public company are insufficient to plead scienter. The rationale for these decisions—that such allegations do not allow district courts to distinguish between cases involving business reversals and those involving potential fraud—applies with equal force to allegations based on Section 302 certifications. After all, CEOs and CFOs of *every* public company must file identical certifications every quarter. If all a plaintiff had to do to allege scienter was point to an officers' certification that the financials contained no misstatements or omissions, the scienter pleading requirement would be eviscerated.

Section 302 certifications have no bearing on the adequacy of scienter allegations. However, the certification requirements of Sarbanes-Oxley do create significant risks, both civil and criminal, for senior officers.

Some analogies to existing law illustrate our point. An executive's alleged desire to protect and enhance his or her corporate position and compensation is insufficient, in itself, to establish motive, because allowing such pleading would ascribe fraudulent motive to virtually every executive of every public company.[4]

Similarly, an allegation that a corporate officer acted in order to enhance the value of his or her personal holdings of company stock also fails to plead scienter. In virtually every public company, corporate executives own shares in the company and are compensated, in part, in the form of shares and/or stock options. To ascribe fraudulent intent to executives simply by virtue of their equity holdings would be to ascribe improper motives to virtually every executive in every public company. Such a "test" would provide no basis for distinguishing a case of fraud from one in which adverse business developments have befallen a company.[5] It is precisely the weeding out of strike suits brought against companies that are guilty of nothing more than poor business conditions that Congress intended when heightening the scienter pleading standards.[6]

Likewise, the mere act of certification required of every public company CEO and CFO cannot, by virtue of its very ubiquity, serve to satisfy, or even support, the factual basis of a scienter allegation.

Substantive Liability Exposure

Wholly apart from its negligible impact on threshold motion practice, however, the certification requirements of Sarbanes-Oxley do create significant risks, both civil and criminal, for senior officers. Thus, should it develop that the company's financials have to be restated, or that a Form 10-K or 10-Q contained material misstatements or omissions, the attention of regulators and the plaintiffs' bar alike will be sharply focused on the CEO and CFO. The core question will be: Did they have a good faith basis for representing that "based on his or her knowledge" the K's and Q's contained no material inaccuracies?

Similarly, the CEO and CFO can expect that they are going to have to justify their representations that the company's disclosure controls and procedures were appropriately designed, that the steps they took to evaluate their effectiveness were reasonably calculated to identify any problems, and that they also took reasonable steps to ensure that internal controls and procedures provided reasonable assurances that the financials fairly present the company's financial condition.

Many law firms have disseminated detailed (and broadly similar) memos that make concrete suggestions about the procedures that public companies should consider adopting. For its part, the SEC has not mandated any particular procedures for conducting the required review and evaluation of its disclosure controls and procedures, although it recommended that issuers create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis.

Of course, it is reasonable, indeed, inevitable that the CEO and CFO will be relying heavily on senior subordinates in the business units to provide accurate information that are the building blocks of the company's filings. The CEO and CFO also will ordinarily find it valuable to insist that the Chief Operating

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Officer, Chief Accounting Officer, the General Counsel, and other senior officers with wide-ranging mandates who are not responsible for a specific business unit—such as members of the management committee, if one exists—review the *entire* draft filing.

But this does not mean that the CEO and CFO can simply *delegate* responsibility to others. It is clear that, to avoid liability, a "clean heart, empty head" defense is not going to work. When the certifications are filed, the two senior-most officers must have had a good faith basis, based on their *own personal due diligence*, for their certification.

Adherence to a rigorous, disciplined internal review process is, at the end of the day, the best way not only to maximize the likelihood that the financials will be accurate, but to mitigate against a liability finding (for the individuals and the company) if something does go wrong. But this general proposition gives rise to three much more concrete and difficult questions of implementation, each of which has profound consequences for the course of any ensuing litigation:

1. To what extent should the company contemporaneously document the quarterly process of preparing certifications?
2. Should a company insist on internal "back up" certifications from the heads of business units and senior officers like the treasurer?; and
3. What assumptions should the company be making about whether the involvement of the General Counsel's office will cloak any of the internal review process with the attorney-client privilege?

Contemporaneous Documentation

As issuers adopt policies and procedures designed to ensure accurate certifications under Section 302, and thus insulate the CEO and CFO from potential civil and criminal liability, it is prudent to bear in mind that virtually all of the steps that a company takes to analyze information and to evaluate the effectiveness of disclosure controls and procedures will, in the event of a litigation that continues past the motion to dismiss stage, be subject to extensive discovery. Indeed, one certain consequence of the adoption of Section 302 of the Act is that every plaintiff's firm in the country will be adding new boilerplate paragraphs to the document requests stored on their hard drives. Every deposition outline for virtually every individual defendant will include a section about the process by which Section 302 certifications were prepared.

One concrete procedural element that the SEC has recommended, for example, is that companies create a "disclosure committee" that will have responsibility for considering the materiality of information and making disclosure decisions. That committee would normally report to senior management, including the CEO and CFO. In order to function effectively, of course, the committee will have to gather and critically review information from various sources within the company. The Committee also will undoubtedly have to create written documents that reflect its deliberations and conclusions. Should these materials be preserved or destroyed on a regular basis?

We suggest that it would be a *bad* idea, in almost all circumstances, for a company to adopt a policy that all documents leading up to the certification decision should be routinely destroyed, both because the company may well need to reconstruct its due diligence process and because of the risk that a factfinder would draw an adverse inference from such destruction. This does not mean, however, that a company should go to the opposite extreme and meticulously preserve every scrap of paper with every handwritten doodle.

Although the records will vary in formality, some record of decisionmaking as a matter of prudence should be retained, so that if there were a later challenge to the reasonableness and good faith of the certifications, the company would have a "paper trail" showing how decisions were made. We therefore think it would be sensible for a company to make some fundamental decisions about the nature and content of the documentation that ought to be preserved from the exercise undertaken each quarter.

In this respect, at a minimum, the committee would want to have minutes that are comparable to those kept by boards of directors. That is, it is unlikely that it would be desirable to have a blow-by-blow description of the committee's deliberations, but it would certainly be

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desirable to reflect the issues presented to the committee, the fact that the committee deliberated on them, and the conclusions reached. Similarly, to the extent that executives in charge of business units are being asked to supply information to their superiors who, in turn, may be preparing "back up certifications" (discussed *infra*), some formal record of the process of information gathering and evaluation should be created. Certainly, any "hard calls" about disclosure, and communications on that subject with the audit committee and the company's outside auditors, ought to be memorialized.

All of these communications need to be created, and document preservation policies need to be crafted, with one eye on the inevitable discovery process that will kick into gear if litigation ensues. Those who participate in the process need to be sensitized to the fact that every email they write and every other document they create will, inevitably, be obtainable as part of the discovery process.

Finally, we think it is worth the expenditure of time, effort, and energy to designate a staff person (perhaps from the General Counsel's office) to be the "librarian" of the certification process, just as investment banks appoint a member of the team to gather and archive materials relating to their due diligence in connection with public offerings. The standing instructions to such a librarian are *not* to keep every piece of paper, but to retain those materials from which the due diligence process can be reconstructed.

Back Up Certificates

Many issuers plan to require "backup" certifications to help ensure the completeness and accuracy of the certifications that must be filed by the CEO and CFO. It seems to us quite reasonable and appropriate that, to ensure the maximum likelihood that the statute will be complied with in all respects, a company would wish to impress on senior officers the importance of scrupulous accuracy by requiring that they submit certifications of information within their sphere of operations.

Requiring back up certifications has several obvious advantages. The head of each business unit will be focused on taking personal responsibility for seeing to it that he or she has established disciplined, standardized procedures that maximize the likelihood of accuracy of information. Especially if issuers schedule the "internal due date" for such back up certifications so that they are complete at least a week or two *before* the statutory certifications must be filed, the company will leave itself some lead time to resolve problems without a "fire drill." And if the CEO and CFO ever have to justify their reasonableness and good faith, it obviously helps to point to such back up certifications.

But it would certainly be desirable to reflect the issues presented to the committee, the fact that the committee deliberated on them, and the conclusions reached.

The question arises, however, whether officers and employees who provide such "backup" certifications have a significant risk of personal liability either in private civil actions or in SEC enforcement proceedings should the information that they certify prove to be inaccurate. We believe that, in the absence of knowing or willful misrepresentations in a backup certification, it is highly unlikely that a backup certification that proves incorrect will subject an officer or employee to a material risk of private civil litigation or an SEC enforcement proceeding. There are several reasons that an officer or employee who provides written backup certification should be, with respect to private civil liability, in no different position than if he or she makes an inaccurate statement in any other kind of oral or written report that is generated in the ordinary course of his or her business activity.

We start with the proposition that the new statute requires certification only from the CEO and CFO and makes no mention of certifications by other persons and imposes no duty on any other person to prepare a certification. Second, unlike the certifications by the CEO and CFO, the backup certifications will not be filed with the SEC or otherwise published. Thus, it is quite unlikely that any investor could plausibly allege that he or she had relied on a statement in a backup certification. Although there are a few recent and notorious cases in which officers of a public company below the CEO and CFO level have been sued in private securities litigation, those are all cases in which the allegation is that the employee actively and knowingly

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participated in fraudulent conduct that resulted in misstatement of the company's financials. If we leave aside cases in which the plaintiff can properly allege such active participation in a fraud, there are few, if any, instances in which a private civil litigant has sued a subordinate officer personally on the theory that his or her internal reports lead the company to issue misleading statements to the public. The reason for this distinction is plain: If the statement by the subordinate employee is not publicly disseminated, it can have no impact on the market price of the market stock and no shareholder can rely on it.

Obviously, it would be appropriate for the Company to advise these officers that even a negligent failure to provide accurate certifications could be cause for disciplinary action or termination. But it seems to us quite unlikely that such employees also would have to worry about private civil litigation.

On the SEC front, the Enforcement Division has discretion in determining the identity of the employees of a company whose conduct merits sanction. The SEC would have the power to discipline a senior officer on the ground that he or she had "aided and abetted" a violation. As to criminal liability, a willful or knowing false certification by an officer who knows that his or her certification will be the basis for a CEO/CFO certification could expose the officer to a potential claim of a violation under 18 USC § 2(b) ("whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States is punishable as a principal"). But, of course, such a result is neither surprising nor unacceptable. Employees can and should be advised that if they file a knowing or willfully false certification, they would have exposure on both the civil and criminal sides, as well as exposure to severe sanctions by their employer. Moreover, such potential individual liability exists regardless of whether a backup certification is signed, if the senior officer has knowingly provided false financial information.

Privilege Issues

Participation by the general counsel's office in the disclosure process will almost certainly not permit a company to take the position that the entire information gathering and evaluative process is protected by the attorney-client privilege. If the general counsel or its staff gives legal advice concerning, for example, the appropriate reserve for a litigation or the legal risks associated with the way a specific disclosure item is handled, then those discrete communications would of course still be privileged.

NOTES

1. These requirements are echoed by Section 906 of the Exchange Act, which also imposes criminal penalties of fines up to $5,000,000 or imprisonment up to 20 years.
2. Release No. 33-8138 (Oct.22, 2002).
3. Plaintiff must allege, of course, that the individual defendant actually made the allegedly false statement of material fact. Under the group-published information doctrine, some courts had found that false information contained in a financial report signed by an officer was sufficient to support an allegation that the officer did, in fact, make the allegedly false statement. *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987). Since the PSLRA, however, many courts have held that the group-published doctrine is no longer viable. *Echavarri v. Cellstar Corp.*, No. 99-1502- CIV-Graham, slip op. at 15 (S.D. Fla. Aug. 3, 2000) ("[T]he simple fact that an individual . . . signed off on public documents containing false information *is insufficient to plead scienter* under the Reform Act") (emphasis added). The issue remains unsettled.
4. *See, e.g., Phillips* v. *LCI Int'l, Inc.*, 190 F.3d 609, 622 (4th Cir. 1999) ("Allegations that 'merely charge that executives aim to prolong the benefits they hold' are, standing alone, insufficient to demonstrate the necessary strong inference of scienter"); *Shields* v. *Citytrust Bancorp.*, 25 F. 3d 1124, 1129 (2d Cir. 1994) (same).
5. *See Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d at 1131 (motive "to enhance the value of [defendants'] personal holdings and options," and then to sell those shares at inflated prices, insufficient to plead scienter); *In Re Carter-Wallace, Inc. Sec. Litig.*, No 94 CIV. 5704 (KTD), 1999 WL 1029713, at *4 (S.D.N.Y. Nov. 10, 1999) (same), *aff'd*, 220 F.3d 36 (2d Cir. 2000); *Leventhal* v. *Tow*, 48 F. Supp. 2d 104, 115 (D. Conn. 1999) ("This motive has been rejected routinely") (citing cases); *Malin v. IVAX Corp.*, 17 F. Supp 2d 1345, 1360 (S.D. Fla. 1998) (allegation that defendant acted to "improve the value of his severance package" insufficient to plead motive).
6. *See Bryant v. Avado Brands, Inc.*, 100 F. Supp. 2d 1368, 1374 (M.D. Ga. 2000) A claim that individual officers were motivated to commit fraud by a desire to consummate various corporate acquisitions is also insufficient. Courts have repeatedly rejected such generalized claims, noting that virtually all public companies would find it desirable to achieve a high stock price as currency for acquisitions. *See Branca* v. *Paymentech, Inc.*, No. Civ.A.3:97-CV-2507-L, 2000 WL 145083, *9 (N.D. Tex. 2000) (allegations that defendants had motive to commit fraud in order to consummate merger were inadequate because complaint failed to demonstrate that merger would not close if stock price fell below a certain level); *Leventhal*, 48 F. Supp. 2d at 115 (allegation of inflating stock value to get more favorable stock-for-stock transaction insufficient to establish scienter). *See also San Leandro Emergency Med. Group Profit Sharing Plan* v. *Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996) (pleading motive to maintain high bond or credit rating failed to allege scienter); *Michael Perino, Securities Litigation After the Reform Act*, § 3.01D.5.c., at 3087 ("As with other allegations . . . generalized allegations that the company intended to make such acquisitions will not establish a strong inference of fraud").

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