Sarbanes-Oxley's CEO and CFO Certification Requires Scienter to Protect Investors

By Nathan S. Slavin, Glen M. Vogel, and Stuart L. Bass

In December 2001, Enron—the nation's seventh-largest company, based on reported revenues—filed for Chapter 11 bankruptcy, touching off an eruption of accounting scandals that rocked the financial world. At the time, Enron's collapse was the largest corporate bankruptcy in American history, bringing down a company with approximately $33 billion in assets. Over a four-year period, Enron's executives engaged in a fraudulent accounting scheme that included overstating profits and understating debts to drive up the stock price. As the scheme unraveled, investors lost tens of billions of dollars as the stock price plummeted from a high of near $90 a share to less than $1 a share.

Both Congress and the public were outraged that a fraud of such magnitude could be committed. At the urging of the President, Congress initiated hearings to examine the Enron collapse and to develop a plan to prevent similar fraudulent financial schemes from occurring in the future.

On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act (SOX). One of the major goals of SOX was to create an environment of greater corporate integrity and investor confidence by holding company officers personally accountable for financial misdeeds. Sections 302 and 906 of SOX, the "certification provisions," require that high-level executives personally certify to the SEC the integrity of the corporation's system of internal controls and the fairness and accuracy of the financial statements.

The hope was that creating a link between the executive and the SEC filings would provide some measure of personal liability, and that investors and potential investors would have more confidence in the markets and the financial industry as a whole. Congress intended the certification provisions to be critical pieces of the statutory regime to prevent corporate corruption and fraud because they subjected corporate officers to personal, civil, and criminal liability unlike ever before. According to early predictions, these provisions would be an effective tool for preventing future scandals and for restoring investor confidence.

المنارة للاستشارات
www.manaraa.com

One could easily surmise that, in light of the above, corporate executives would be less likely to get away with certifying false or fraudulent financial information to the SEC and the public. Nevertheless, the question remains: Is submitting a false certification under SOX enough to hold an executive personally responsible for subsequent losses? The answer to that question is a resounding no. To date, no court has held that submitting false certifications alone is sufficient to impose liability on corporate executives. The query does not end because, if filing false certifications alone is not sufficient to proceed with a claim, then what else must a plaintiff show? The answer exists within the definition of a complex little word: "scienter." The issue is further complicated because the statute itself identifies two different standards for proving scienter, and courts have been inconsistent when it comes to determining what conduct is required to satisfy either of these definitions.

SOX Certification Requirements

Scienter refers to the required "state of mind" necessary to prove the crime at issue. Scienter, in this context, is identified as the mental state embracing intent to deceive, manipulate, or defraud. Under SOX, the specific mental state required for an executive to be held personally liable is "knowingly—that is, the executive must have knowingly certified and submitted a false financial statement to the SEC in order to be subject to SOX's civil and criminal penalties." The personal certification provisions significantly changed the landscape for professionals in the financial sector and for investors because they effectively restructured corporate financial reporting requirements, which impacted the self-regulation previously engaged in the accounting profession. Section 302 of SOX requires the CEO and CFO of a reporting company to "certify" the correctness of the financial statements and the adequacy of the system of internal controls. Further, section 906 requires that the corporate officer also certify that the information contained in the 10-Q and 10-K reports filed with the SEC comply with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934.

The use of the word "certify" was intentional by the legislators who crafted these specific provisions. The *Congressional Record* even seems to suggest that the SOX certification requirements could serve as a "guarantee" by the CEO and CFO of the fairness of the company's financial report and the adequacy of the system of internal controls. In his testimony before the Senate, G. William Miller, former chairman of the Federal Reserve Board and former Treasury secretary, stated plainly and poignantly that the certification provisions will act as the executive's "personal stamp of approval" with regard to the financial state of affairs of the corporation (Testimony of former Treasury Secretary G. William Miller, Senate Judiciary Subcommittee on Crime and Drugs, July 24, 2002).

With the passage of SOX, it was believed that the SEC and investors would possess a greater ability to hold a corporation's officers accountable for financial and accounting misdeeds. Thus, by certifying, the CEO and CFO have assured investors that the report does not contain any untrue statements of material fact that would make the statement misleading. The process of certification makes the attesting officer responsible and liable for creating and maintaining internal controls. The CEO/CFO certification requirement is further bolstered by the inclusion of section 906, which requires the CEO and CFO to sign a separate statement certifying that the periodic financial reports fully comply with the Securities Exchange Act. Corporate officers must, to the best of their knowledge, affirm that the financial statements and disclosures fully comply with provisions of the act and that they fairly present the operations and financial condition of the issuer in all material respects. One significant aspect of section 906 is that it provides for criminal liability for failing to make such certification or falsely certifying financial statements.

Section 906 provides for a two-tiered penalty scheme for corporate officials who knowingly certify and submit false statements. Under section 906, whoever,

> (1) certifies any statement as set forth in subsections (a) and (b) of this section *knowing* that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or
>
> (2) *willfully* certifies any statement as set forth in subsections (a) and (b) of this section *knowing* that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both. [emphasis added]

Under both tiers, to be liable, the corporate executives who certify statements must do so knowing that the periodic report accompanying the statement does not comport with all SEC filing requirements. The term "knowing" has different definitions depending on the state of mind of the executive and severity of the potential penalty. Under section 1350(c)(1), the term knowing refers to a general intent standard; knowing does not necessarily require actual knowledge, but also covers acting with an awareness of the high probability of the existence of the statement's falseness. To certify financial statements knowing them to be false simply means to certify the financial statements intentionally, voluntarily, and with awareness of their duplicity, rather than by mistake or accident. It is important to point out that, while knowledge of the law itself is not required, the penalties are not triggered based on mere negligence or recklessness.

This definition is different from the "knowing" requirement set forth in section 1350(c)(2). Here, the new 20-year felony provision applies to corporate officials who "willfully" certify financial statements that they know to be false. "Willfully" denotes a specific intent standard. A corporate executive who certifies financial statements that he knows to be false is not guilty under this section unless, in addition to knowing what he was doing, he voluntarily and intentionally engaged in conduct that he knew was illegal. Congress intended to require a more particularized showing of knowledge in order to access the tougher criminal penalties. This suggests that an executive must have knowledge of the specific law or rule that his conduct is alleged to violate—meaning the certification provisions of SOX.

Not long after its enactment, like many other federal statutes, the validity and statutory intent of SOX was tested in the federal courts—particularly the issue of the effectiveness of the certification require-

www.manaraa.com

ments. After almost a decade of litigation and interpretation, it appears that the certification requirements may not be as effective as originally believed and that CEO and CFO personal accountability will likely depend on the particular court's interpretation of the facts necessary to establish scienter. As a result, the certification requirements appear to fall short of providing the type of guarantee that was originally envisioned by the architects of the SOX legislation.

Congressional Intent Versus Judicial Interpretation

After the passage of SOX, and as corporations continued to collapse amid financial scandals, the certification provisions set forth in sections 302 and 906 began to be tested in the courts as litigants looked to recover their losses directly from the corporate officers. When interpreting these provisions, the courts often looked back at the *Congressional Record* in an effort to accurately ascertain the legislative intent based on the specific language used in sections 302 and 906. Former U.S. Senator Joseph Biden (D-Del.) made exhaustive remarks regarding the purpose and legislative intent behind the various provisions of SOX. Biden was one of the primary drafters of the statute, along with Senator Orrin Hatch (R-Utah).

Biden offered that, when an executive certifies a statement knowing that it is false, it implies that it has been falsified intentionally, voluntarily, and with awareness of its duplicity rather than by mistake or accident. Thus, for a violation of the statute to be present, there is no requirement that litigants show that the corporate officer intended to violate the statue; they merely need to prove that the officer knew that the financial statement was materially misleading or inaccurate at the time they completed the certification. This would support the scienter requirement for section 18 USC section 1350(c)(1)—the provision imposing lesser criminal penalties for a knowing violation. That is not to imply that the officer certifying the statement may avoid liability by playing semantics; rather, the drafters felt that "the certifying officer should be judged by whether they have been diligent, exercised due care, established procedures for verification, made adequate investigations and provided appropriate supervision" (Miller, July 24, 2002).

During the Senate hearings, Biden stated:

> It is our intent that courts impose a duty on these individuals to be reasonably informed of the material facts necessary to prepare financial information for submission to the SEC for dissemination to the public. … To act knowingly … is not necessarily to act only with positive knowledge, but also to act with an awareness of the high probability of the existence of the fact in question. …
>
> On the other hand, the standard articulated here is not tantamount to negligence or recklessness. … We note the well-established proposition that conscious avoidance of certain facts should not provide immunity from prosecution… in contrast, if lower level corporate officials conspire to hide the true financial health of a company from the CEO, for whatever reasons, the CEO will not be held liable if he or she did not know the facts.
>
> Specific intent to commit crimes … might be negated by, for example, proof that a defendant relied in good faith on advice of counsel … the so called "reliance on expert" defense is held to apply only when the defendant can demonstrate that they fully disclosed all relevant facts to the accountant or attorney and that they relied in good faith on that expert's advice. (Remarks of Sen. J. Biden, S. 5329, April 11, 2003.)

In the hearings, the drafters were emphatic that the provision setting forth more significant criminal penalties would require a heightened state of mind from that of merely knowing. Here, they specifically used the word "willful" and characterized it as "knowledge that the prohibited conduct is unlawful." This means that, in order to be subject to the 20-year felony and $5 million fine provision, not only must a CEO or CFO know that he is submitting materially misleading or inaccurate financial statements—he also has to know that he is violating the specific provisions of SOX. In other words, a CEO or CFO who certifies financial statements that he knows to be false is not guilty under section 1350(c)(2) unless, in addition to knowing what he was doing, he voluntarily and intentionally engaged in conduct that he knew was against the law.

Based on these lengthy and detailed comments from Biden and other congressional representatives, it is obvious that Congress gave significant thought to the "state of mind" or scienter requirement necessary to hold CEOs and CFOs personally accountable. At the same time, it appears that no clear bright-line test was created for litigants to know what they needed to establish, in order to demonstrate that CEOs and CFOs possessed each of the requisite states of mind; that is: What facts are necessary to establish that a CEO or CFO acted knowingly or willfully? Since Congress did not elaborate on this component, CEOs, CFOs, and litigants were left with little guidance on the subject. When Congress has not been unequivocal or completely clear in its drafting, then the courts must step in and interpret this web of language to make sure CEOs and CFOs do not unwittingly get entangled in the statute's snare.

SOX Certifications and Scienter

Shortly after its enactment, many executives and financial professionals argued that SOX was an overreaching, expensive, and excessive reaction to recent corporate scandals. CEOs and CFOs were concerned about the potential personal liability and started looking for ways to minimize their risk by relying on "backup" or subcertification from lower level officers or managers to support their own certifications. This reaction appears to be unjustified because, unbeknownst to most CEOs and CFOs, litigants already had an extremely high hurdle to clear just to initiate a claim under SOX and its predecessor statutes.

In 1995, Congress heightened the pleading standard for securities fraud claims by passing the Private Securities Litigation Reform Act (PSLRA). Under the PSLRA, a plaintiff is required to "state with particularity, facts giving rise to a strong inference that the defendant acted with the required state of mind" necessary to prove fraud. If an investor wants to make a claim for a violation of SOX certification provisions, he is required to state with particularity, facts giving rise to a strong inference that the defendant (the CEO or CFO) acted with the required "state of mind" necessary to prove fraud.

The PSLRA requires that plaintiffs plead the following four critical elements in order

المنارة للاستشارات
www.manaraa.com

to avoid having their case dismissed: 1) that there was a misstatement or omission of material fact, 2) that the misstatement or omission was made with scienter, 3) that the plaintiff must have relied on the misstatement or omission, and 4) the plaintiff suffered a legally recognizable injury. Typically, litigants would surmise that proof that the corporation's financial statements were false would be enough to establish intent; however, courts have routinely held that subsequent revelations that financial statements were false could not, standing alone, create this strong inference of scienter. More troubling is that, to date, what facts are necessary to establish scienter appear to be different, depending on where a litigant initiates his case.

When the courts are asked to assess the issue of statutory interpretation, it is not uncommon for federal appellate courts to disagree on a standard. In the case of CEO and CFO certifications, the federal circuit courts are split into three different camps when it comes to determining which additional facts are required to satisfy the pleading requirements for each of the two levels of scienter set forth in SOX. One camp consists solely of the Ninth Circuit; another is composed of the Second and Third Circuits; and the last and largest camp encompasses the First, Fourth, Fifth, Sixth, Seventh, Eighth, Tenth, and Eleventh Circuits.

The Ninth Circuit developed the strictest interpretation of the pleading standard in the case of *In re Silicon Graphics Inc. Securities Litigation*. The court held that, at a minimum, a plaintiff must show "particular facts giving rise to a strong inference of deliberate or conscious recklessness." The Ninth Circuit's holding has been described as creating a "super-recklessness" standard—one that has been criticized as being too restrictive by other circuit courts.

Conversely, the Second and Third Circuits have employed what can be characterized as the most pro-plaintiff standard in the country. The Second and Third Circuits agree that plaintiffs must allege facts showing 1) both motive and opportunity, or 2) strong circumstantial evidence of conscious misbehavior or recklessness.

Sitting somewhere in the middle between the two extremes are the eight remaining circuits. Although there is not a clear consistency among these eight circuits, it is fair to say they agree that, as a general rule, certifications alone—or merely pleading motive and opportunity—are not sufficient to demonstrate scienter, and that a plaintiff must also provide facts sufficient to support a strong inference of recklessness.

The federal district courts are even more inconsistent than the circuit courts when it comes to addressing the PSLRA's "strong inference" of scienter. As noted in a 2002 study of 167 district rulings regarding the issue, researchers found "aggregate patterns of behavior that are, to a remarkable degree, statistically indistinguishable from a 'coin-toss' model of judicial behavior" (Joseph A. Grundfest and A.C. Pritchard, "Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation," *Stanford Law Review*, vol. 54, p. 678, 2002). The authors of the study posit that judges who are unconstrained by appellate precedent frequently adopt minimalist strategies that avoid the need to interpret the statute. They rule either that a complaint is sufficiently strong that it satisfies the most stringent conceivable articulation of the pleading standard, or that it is so deficient that it fails the most forgiving articulation, without explaining how the strong inference standard is to be interpreted or applied.

In the case of CEO and CFO certifications, the federal circuit courts are split into three different camps when it comes to determining which additional facts are required to satisfy the pleading requirements for each of the two levels of scienter set forth in SOX.

Differing Court Opinions

In *Garfield v. NDC Health Corp.*, the U.S. Court of Appeals, Eleventh Circuit, rejected the plaintiffs' assertions that the mere fact that the corporate executives signed the SOX certifications was sufficient to establish a strong inference of scienter, maintaining that SOX did not indicate an intent to provide any altering of the pleading requirements under the PSLRA (446 F.3d 1255 [11th Cir. 2006]). In *Garfield*, the plaintiffs filed a section 10(b) claim against NDC Health Corp. and its officers, asserting that NDC Health Corp. violated GAAP principles, misstated the value of a failed investment, and engaged in channel stuffing. The court ruled that the pleading requirement could not be satisfied unless the person making the certification had reason to know "due to the presence of glaring accounting irregularities, or other 'red flags,' that the financial statement contained material misstatements or omissions."

Similarly, in *Central Laborers Pension Fund vs. Integrated Electrical Services Inc.*, the U.S. Court of Appeals, Fifth Circuit, also rejected the plaintiffs' assertion that scienter could be inferred on the basis of the SOX certifications alone. In *Central Laborers Pension Fund*, the plaintiff shareholders commenced a class action against Integrated Electrical Services (IES), the CFO, and two previous CFOs, alleging that they made false and misleading statements regarding the company's financial condition in violation of section 10(b) of the Securities Exchange Act (497 F.3d 546, 549 [5th Cir. 2007]).

Several district courts have reached a similar result. The District Court for the Western District of Washington dismissed a complaint stating the SOX certifications by themselves were insufficient to establish a strong inference of scienter (*In re WatchGuard Securities Litigation*, 2006 U.S. Dist. Lexis 27217 [W.D. Wash., Apr. 2006]). Similarly, the U.S. District Court for the District of New Jersey held

www.manaraa.com

that the inference of scienter is not established merely from SOX certifications, without stating facts outside the certifications that would indicate the defendants had personal knowledge about errors in the statements or that the defendants were aware of any signs of wrongdoing (*In re Intelligroup Securities Litigation*, 527 F. Supp. 2d 262 [D.N.J. 2007]). In Delaware, the court in *City of Roseville Employees' Retirement System v. Horizon Lines Inc.* dismissed the complaint, following the precedent in Washington and New Jersey, because the plaintiffs relied on the certifications alone and did not plead "scienter" with sufficient particularity to show the executives were aware, or should have been aware, of a rate fixing scheme when they made the certifications (686 F. Supp. 2d 404 [D. Del. 2009]).

> **Corporate officers who sign off on certifications have not provided investors with a guarantee.**

Despite the previous examples of cases wherein the courts held that SOX certifications alone were not sufficient to establish scienter, there have been a few cases where plaintiffs have been successful based on the inclusion of additional facts that demonstrate scienter along with the submission of fraudulent SOX certifications. In *In re Lattice Semiconductor Corp. Securities Litigation*, plaintiffs alleged the defendants manipulated financial statements by basing early increased revenues on production of goods that had been shipped to distributors, but had never actually been sold to retailers. Plaintiffs argued that the SOX certifications signed by the defendant gave rise to an inference of "at least deliberate recklessness" (2006 U.S. Dist. Lexis 262 [D. Or. 2006]). Here, the District Court held that the SOX certification signed by the defendants, combined with allegations in the complaint that the officers regularly attended finance meetings, received special reports, and micromanaged the corporation were enough to create "a strong inference of scienter" sufficient to meet the pleading requirements of the PSLRA.

Similarly, in *Croker v. Carrier Access Corp.*, the plaintiffs contended that, in addition to filing false SOX certifications, defendant Carrier overstated its earnings and further failed to disclose information regarding its ability to sell products profitably (2006 U.S. Dist. Lexis 48603 [D.C. Colo., July 2006]). The defendants argued that the SOX certification had no bearing on the issue of scienter, but the District Court disagreed and held that the SOX certifications constituted one of several factors the courts may consider when looking at the totality of circumstances needed to evaluate scienter. The court noted that, given the defendants' authority, the extent of the company's misstatements, and the defendants' motive and opportunity, there was a strong inference of scienter.

Because the circuit courts seemed to be mired in disagreement with regard to the issue of satisfying the PSLRA pleading requirements, the Supreme Court felt compelled to intervene. In *Tellabs Inc. v. Makor Issues & Rights Ltd.*, the Supreme Court held that when determining whether the pleaded facts give rise to a "strong" inference of scienter, the court must take into account plausible opposing inferences (551 U.S. 308 [2007]). Justice Ruth Bader Ginsburg further explained this analysis by stating that "the strength of an inference cannot be decided in a vacuum" and that a court must consider "non-culpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." In a nutshell, the Supreme Court instructed lower courts to accept the allegations set forth in the complaint as true, and then determine if a reasonable person would find the inference of scienter is at least as strong as any competing interest. If the answer to this analysis is no, then the inference is not "strong" under the PSLRA.

In reality, the *Tellabs* decision strengthens the pleading standard set forth by Congress in the PSLRA, and creates a uniformly high bar for pleading scienter in securities fraud cases—that is, a securities complaint would survive a motion to dismiss "only if a reasonable person would deem the inference of scienter could be at least as compelling as any opposing inference one could draw from the facts alleged."

Based on the above, while courts seem to have universally concluded that SOX certifications alone are not sufficient to establish scienter, they have not agreed on what additional facts are required to meet the pleading requirements for scienter in accordance with the PSLRA.

Effectiveness at Deterring Fraud

It is apparent that requiring senior executives to certify regulatory filings pursuant to SOX is not quite the solution to the corporate financial scandals that Congress or investors had hoped for. Corporate officers who sign off on certifications have not provided investors with a guarantee, and will only be liable if it can be shown that they either intentionally filed false statements or disregarded red flags related to the accuracy of the company's statements.

Moreover, courts have generally held that the strong inference of scienter that is required under the pleading requirements of the PSLRA will only be satisfied if the executives had reason to know or should have suspected, due to obvious accounting irregularities or other indicators, that the financial statements were flawed with material omissions or misrepresentations.

Is this really what Congress intended when it passed SOX? It does not seem likely after reading the comments of Senator Biden and former Treasury Secretary Miller. The certification requirement is a powerful incentive for corporate executives to do the right thing; however, because of the requirement that a plaintiff must still establish a strong inference of scienter at the pleading stage, the certification requirement alone is not quite the fraud-preventing tool it was originally thought to be. In the end, the requirement that an officer sign a certification form will serve to deter some, if not all, from engaging in fraudulent activity. ❑

Nathan S. Slavin, PhD, CPA, *is a professor and chair,* ***Glen M. Vogel, JD,*** *is an assistant professor, and* ***Stuart L. Bass, JD, MPA,*** *is a professor, all in the department of accounting, taxation and legal studies in business at the Frank G. Zarb School of Business at Hofstra University, Hempstead, N.Y.*

المنارة للاستشارات
www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات
www.manaraa.com