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Minding Your 302s: Assessing Potential Civil, Administrative and Criminal Liability for False Financial Statement Certifications
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By

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In the wake of the scandals of the Enron era, Congress sought to hold corporate chief executives and chief financial officers accountable for false financial statements. Congress intended to cause CEOs and CFOs to take more seriously the integrity of financial reporting by requiring them to personally certify in each annual and quarterly report, among other things, that based upon their own knowledge the financial statements included in the report fairly present in all material respects the financial condition and results of operations of the company. This requirement was enacted as Section 302 of the Sarbanes-Oxley Act of 2002,[2] which directed the Securities and Exchange Commission ("SEC") to adopt rules requiring such certifications.

On August 27, 2002, the SEC adopted the required certification regulations, immediately requiring that CEOs and CFOs certify financial and other information in their companies' quarterly and annual reports.[3] Because it all happened so quickly, there is uncertainty as to the precise effect of these certifications. CEOs and CFOs of large public companies can only know so much; it is not possible for them to have sufficient information to **guarantee** that there are no errors or irregularities in financial and other information being reported to headquarters, particularly from far flung subsidiaries and remote offices. Thus, several questions arise: what happens if the annual or quarterly filing that was certified contains immaterial errors?; what happens if, despite certifiers taking reasonable steps to assure that filings contain no untrue statements or material omissions, they nevertheless fail to detect fraud at the company? These sorts of questions have caused great anxiety among certifiers, while the statute and certification regulations have offered little to allay such anxiety.

Recently, however, we have begun to gain some insight into the answers to such questions. Over the last few years, courts have grappled with these issues, regulators have examined certifications of companies that have been found to have filed quarterly and annual reports containing untrue statements (including materially misstatement financial statements), and criminal prosecutors have made use of 302 certifications as another tool in their arsenal to pursue wrongdoers. These recent developments give us

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[2] 15 U.S.C. § 7241

[3] *See* SEC Rule 13a-14, which is codified at 17 C.F.R. 240.13a-14.

some idea of what it means for a CEO and CFO to submit 302 certifications of annual and quarterly financial statements.

That, however, does not mean that there is clarity in the world of 302 liability. There isn't. The short answer to most questions about whether a 302 certification that turns out to be untrue will result in personal liability is a simple one: it depends. It depends on whether you are asking about civil or criminal liability. It depends on the other surrounding facts. Most importantly, it depends on what the certifier can be proven to have known. In short, assessing potential 302 liability is a fact intensive exercise, but now practitioners have some guideposts for assessing the facts their clients present.

Certification Requirements: Statutes and Regulations

Under Section 302, CEOs and CFOs are required to certify, in each annual and quarterly report, six things which can be broken down into three fundamental categories: (1) the report does not contain any untrue statements or material omissions; (2) the financial statements fairly present, in all material respects, the financial condition of the company; and (3) the certifiers have evaluated the company's internal controls and disclosed any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.[4]

Interestingly, Section 302 does not include a liability provision. Congress was silent as to whether, and if so how, a CEO or CFO should be held accountable for filing a

[4] Under 302, a company's CEO and CFO must certify that:

a) that they have reviewed the report;

b) that, based on their knowledge, the report does not contain any untrue statements or omit to state a material fact necessary to make the statements made not misleading;

c) that, based on their knowledge, that the financial statements fairly present in all material respects the financial condition, results of operations and cash flows of the company for the periods presented in the report;

d) that they are responsible for establishing and maintaining internal controls; they have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities; they have evaluated the effectiveness of the issuer's internal controls within 90 days prior to the report; and they have presented their conclusions about the effectiveness of their internal controls based upon their evaluation as of that date;

e) that they have disclosed to the company's auditors and audit committee all significant deficiencies 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 they have identified for the issuer's auditors any material weaknesses in internal controls; as well as any fraud, whether or not material, that involves management and other employees who have a significant role in the issuer's internal controls; and

f) that they have indicated whether there were significant changes in internal control subsequent to the date of their internal control evaluation. 15 U.S.C. § 7241(a)(1)-(6)/

false 302 certification.[5] This is in stark contrast to Section 906 of Sarbanes-Oxley, which expressly provides for penalties for false 906 certifications.

Section 906 requires a far simpler certification with each periodic report containing financial statements stating only two things: 1) that the financial statements comply with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and, 2) that "information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[6] This section includes criminal penalties for those who make a 906 certification "knowing that the periodic report" does not comport with the applicable requirements and for those who "willfully" certify a report that does not comport with applicable requirements. Like Section 302, Section 906 is silent as to civil or regulatory liability.

Section 302 Liability in Private Civil Actions

Soon after Sarbanes-Oxley was enacted, plaintiffs' lawyers started including Section 302-related claims in their securities claims and defendants have been challenging them. Recently, courts have had the opportunity to assess those claims. These analyses are instructive.

The first reported case dealing with 302 certifications appears to be *Higginbotham v. Baxter Int'l*, 2005 WL 1272271 (N.D. Ill. May 25, 2005), in which plaintiffs argued that the 302 certifications concerning the adequacy of the company's internal controls were false and, accordingly, the court could infer that Section 10(b)'s scienter requirement was met as to the individuals signing those certifications. *Id.* at *5. The *Higginbotham* court rejected this argument because plaintiffs provided "no specific allegations as to what the deficiencies in the controls were, nor [did they provide] any specific allegations as to [the certifying executives'] awareness of those deficiencies." *Id.*

The next such case was *In re Lattice Semiconductor Corp. Secs. Litig.,* 2006 U.S. Dist. LEXIS 262 (Jan. 3, 2006 Dist. Ore.). In *Lattice Semiconductor*, plaintiffs alleged a

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[5] In the release adopting Section 302, the SEC indicated that liability for a false certification would be based on already existing SEC rules and case law. The principal executives and financial officers of an issuer already are responsible as signatories for the issuer's disclosures under the Exchange Act liability provisions. They can also be liable for material misstatements or omissions under general antifraud standards and under the SEC's authority to seek redress against those who cause, aid or abet securities law violations. An officer providing a false certification potentially could be subject to Commission action for violating Section 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating Section 10(b) and Rule 10b-5.

A false certification also may have liability consequences under Sections 11 and 12(a)(2) of the Securities Act, where a quarterly or annual report is incorporated by reference into a registration statement on Form S-3 or F-3 or into a prospectus filed pursuant to Securities Act Rule 424(b). In addition, it is possible that a willful and knowingly false or misleading statement with respect to a material fact could lead to criminal sanctions under Section 32(a) of the Exchange Act.

[6] 18 U.S.C. § 1350 (a)-(b).

series of accounting errors that resulted in materially misstated financial statements. In that case, plaintiffs argued that false 302 certifications raised a strong inference that the CEO and CFO were, at a minimum, deliberately reckless, thereby satisfying Section 10(b)'s scienter requirement. *Id.* at 45-46. Defendants responded by arguing that if "these certifications raised a strong inference of *scienter*, every corporate officer who signed a certification for a Form 10-Q or 10-K filing that was later found to be incorrect would be subject to a securities fraud action." *Id.*

The *Lattice Semiconductor* court sided with plaintiffs, holding that the 302 certifications in that case did, in fact, give rise to an inference of scienter "because they provide evidence either that defendants knew about the improper journal entries and unreported sales credits that led to the over-reporting of revenues (because of the internal controls they said existed) or, alternatively, knew that the controls they attested to were inadequate . . . ." *Id.* at 50. However, the 302 certifications were not viewed in isolation: "The Sarbanes-Oxley certifications, *in combination with plaintiffs' allegations* of regular finance meetings, extensive access to databases, periodic reports and special reports, and the allegations that they were micromanagers, are sufficient to create a strong inference of actual knowledge or of deliberate recklessness." *Id.* at 50-51 (emphasis added).

Soon after *Lattice Semiconductor*, the court in *In re WatchGuard Secs. Litig.*, 2006 U.S. Dist. LEXIS 272717 (W.D.Wash., April 21, 2006), considered allegedly false 302 certifications in the context of a private Section 10(b) action. In *WatchGuard*, plaintiffs alleged that the defendant company had made material misstatements about interest expenses and revenue recognition in its financial statements. Plaintiffs also contended that WatchGuard's quarterly 302 certifications were themselves actionable misstatements on which they could base a Section 10(b) and Rule 10b-5 claim. Plaintiffs also argued that the certifications demonstrated scienter under the Ninth Circuit's "deliberate recklessness" standard,[7] because the certifying individual defendants either knew about WatchGuard's revenue recognition problems or were "deliberately reckless in not obtaining the information or conducting the investigations described in their certifications prior to publishing the false financial statements." *Id.* at 29.

The *WatchGuard* court rejected plaintiffs' argument, holding that the individual defendants' 302 certifications were, by themselves, inadequate to support a strong inference of scienter. *Id.* at 27-30. In so holding, the court stressed that the failure of plaintiffs to adequately plead scienter is what doomed their 302 argument. "In a case like this one, however, where the court finds no strong inference that any Defendant was at least deliberately reckless in issuing corporate earnings statements, the court has no basis for a strong inference that the Sarbanes-Oxley certifications were culpably false." *Id.* at

[7] While other Circuits have not used a "deliberate recklessness" standard, it is widely recognized that "recklessness" can form sufficient scienter upon which to base an action Section 10(b) claim. *See Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *SEC v. The Infinity Group Co.*, 212 F.3d 180 (3rd Cir. 2000).

32. In so holding, the *WatchGuard* court held that the requirements of Section 302 did not operate to change the scienter requirements of Section 10(b). *Id.*

Another recent case, *Marie Limantour v. Cray Inc., et al.*, 2006 U.S. Dist. LEXIS 27186 (W.D. Wash., April 27, 2006), followed the reasoning of *WatchGuard* in assessing claims that the individual defendants had issued false or misleading statements when they signed their 302 certifications because the defendant company did not, in fact, have adequate internal controls. While the court concluded that the complaint adequately alleged that the 302 certifications were false, it nevertheless held that plaintiffs had failed to plead adequately scienter.

Based upon the reported private securities cases thus far, it appears that that Section 302 certifications that turn out to be inaccurate do not give rise to independent private claims under the securities laws, nor do they appear to alter the fundamental standards that are applied in Section 10(b) actions. Rather, they are viewed by courts in the overall context of a case and only bear on civil liability when other pleaded facts create a strong inference of scienter against the 302 certifier.

Section 302 Liability in Civil and Criminal Government Actions

While 302 certifications have been litigated on the familiar battleground of Section 10(b) in private litigation, federal securities regulators and federal criminal prosecutors have been making use of 302 certifications in bringing actions against CEOs and CFOs.

The first notable prosecution for filing a false certification was based not upon Section 302, but upon Section 906. Federal prosecutors in the HealthSouth case obtained an indictment of Richard Scrushy for, among other things, filing false 906 certifications. *See United States v. Scrushy*, Indictment, Counts 42-50. The charges against Scrushy were based upon two statutes: 18 U.S.C. § 1001(2) (making materially false statement to government) and 18 U.S.C. § 1350(c)(2) (criminal liability under Sarbanes-Oxley for 906 certification). Although the prosecutors did not convince the jury to convict Scrushy, we can expect the Department of Justice to bring similar cases in the future.

With respect to 302 certifications, both the SEC and the Department of Justice have recently used such certifications as a basis for civil and criminal liability for financial fraud. On June 7, 2006, the SEC announced the filing of a settled civil injunctive action against Joseph P. Micatrotto, Sr., the former CEO of Buca, Inc. *See SEC Litig. Release No. 19719* (June 7, 2006). Two weeks later, the U.S. Attorney's Office for the District of Minnesota announced that it had reached a plea agreement with Mr. Micatrotto in which he agreed to plead guilty to certain felonies including, among other things, filing a false 302 certification. *USAO Press Release*, (June 20, 2006). The *Micatrotto* case provides some clues as to potential theories of administrative and criminal liability stemming from the filing of false 302 certifications.

According to both the SEC complaint and the USAO indictment, Buca's 10K reports and proxy statements which were incorporated by reference into Buca's 10Ks, for several years materially understated Micatrotto's annual compensation and several related-party transactions which benefited Micatrotto. *SEC v. Micatrotto*, Complaint ¶¶10,12-14. Micatrotto, among other things, used company funds to purchase and renovate a villa in Italy that was titled in the name of himself and his wife, and he obtained company reimbursement for his personal and business expenses, sometimes receiving reimbursement for the same expense multiple times.

While Micatrotto's annual compensation was significantly underreported by between 27% and 74%, the complaint contains no allegations that this amount was material to the company's financial statements as a whole. The basis of the SEC alleged that Micatrotto knew that the 10K reports he certified contained untrue statements of material fact or material omissions, but not that those untrue statements caused Buca's financial statements to no longer fairly present the financial condition of the company. *SEC v. Micatrotto*, Complaint ¶33. The SEC's complaint alleged:

> Specifically, Micatrotto certified that he had reviewed the [10Ks] and that, based on his knowledge, the filings did not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and based on his knowledge, the financial statements and other financial information included in the reports fairly presented in all material respects the financial condition, results of operation, and cash flows of Buca of, and for, the periods presented in the annual reports."

SEC v. Micatrotto, Complaint ¶32. However, there is no allegation that the financial statements did not fairly present the financial condition of the company. The SEC's allegations are based on inadequate internal controls, rather than misstatements in the financial statements of the company. Nevertheless, both the SEC and the USAO chose to seek severe penalties against Micatrotto for knowingly certifying untrue statements in Buca's 10Ks. In this settled matter, Micatrotto consented to a fine, an order of disgorgement, and a director and officer bar.

On the basis of this same conduct, the USAO decided to indict Micatratto for wire fraud. The *Micatrotto* criminal indictment is more straightforward than the SEC's case. The USAO charged Micatrotto with knowingly filing false 302 certifications in order to keep his self-dealing a secret. In other words, the false 302 certifications were used to further a scheme to defraud. As soon as the 302 certifications were transferred, via wire, to the SEC's EDGAR system, Micatrotto had, under their theory, committed wire fraud pursuant to 18 U.S.C. §§ 1343 & 1346.

It is important to contrast the approach used by the prosecution in the Micatrotto case with that used with Scrushy in HealthSouth. Because the HealthSouth prosecutor relied on Section 906 certifications, he was saddled with two requirements above and

beyond those of Section 302. First, liability under Section 906 arises when the report that is the subject of the certification fails to fairly present, ***in all material respects, the financial condition and results of operations*** of the Company. Second, as a criminal statute, a violation of Section 906 is subject to the much higher standard of proof for criminal prosecutions. Cases brought under Section 302 are likely to be subject to a lower standard of proof (generally clear and convincing evidence as for fraud cases generally). The scope of the 302 certification, however, is not limited to material misstatements of the financial condition of the company. 15 U.S.C. § 7241(a)(5). Thus, while Micatrotto's personal purse padding subjected him to liability under Section 302, it probably was not significant enough to the financial condition of the company as a whole in order to trigger liability under Section 906.

Micatrotto also reveals that Congress' decision not to include an explicit criminal remedy in Section 302 is no real impediment to criminal prosecution based upon that section. Because Micatrotto's false 302 certifications were part of a fraudulent scheme, the federal prosecutors were able to use the federal wire fraud statute. The 302 certifications were false, they were part of the scheme by which Micatrotto was alleged to have profited through fraud, and thus the wire fraud requirements were met.

False 302 certifications have also become part of the emerging stock-option backdating scandal. On July 20, 2006, the SEC and the Department of Justice announced jointly that they had proceeded against executives of Brocade Communications Systems, Inc. ("Brocade"), with regard to a scheme by which the Brocade CEO and Vice President of Human Resources had conspired to falsely back date option grants. *See* Criminal Complaint, *United States v. Gregory L. Reyes and Stephanie Jensen*, Cr: 3 06 70450 (N.D. Cal. Jul 20, 2006) and Complaint, *Securities and Exchange Commission v. Gregory L. Reyes, Antonio Canova, and Stephanie Jensen*, C 06 4435 (N.D. Cal., July 20, 2006).

According to the SEC's complaint, Brocade's CEO and VP of Human Resources had, over the course of a number of years, purposefully backdated stock option grants, knowing that doing so would cause material overstatements of Brocade's income in quarterly and annual filings. When Brocade's CFO joined the company and assumed the position of CFO, he learned of the backdating practice, and did nothing to stop it or cause it to be disclosed in Brocade's annual and quarterly reports. Moreover, the CFO joined the CEO in falsely certifying under Section 302 that the reports did not contain any untrue statements or material omissions, the financial statements fairly presented in all material respects the financial condition of the company, and the CEO and CFO had disclosed to the company's auditors deficiencies in internal controls and any fraud, whether or not material, that involved management or other employees who had a significant role in the company's internal controls. *SEC v. Reyes*, Complaint ¶¶ 56-63.

The federal prosecutors filed their criminal complaint against the CEO and the VP of Human Resources only. The criminal complaint alleges securities fraud (SEC Exchange Act Section 10(b)). It does not mention the false 302 certifications, despite the fact that the SEC's complaint includes allegations of material misstatements in the financial statements.

So, What Do We Make of All This?

Looking at the emerging case law, it appears that 302 certifications do not substantially change the potential liabilities of certifying CEOs and CFOs, with two important exceptions. The first exception is that CEOs and CFOs are now required to review and evaluate internal controls for financial reporting and disclosure controls. Thus, a certifier who can prove a thorough evaluation done in good faith is more likely to avoid being charged with filing a false 302 certification than a certifier who cannot do so. The second exception is that a 302 certification of *immaterial* misstatements or omissions may subject a certifier to liability to the extent that they are part of a larger fraudulent scheme. In such a case, a false 302 certification may constitute evidence supporting charges of criminal securities fraud or criminal mail or wire fraud.