

## Using Sarbanes-Oxley Certifications to Plead Scienter

By Howard S. Suskin and Jennifer M. Lawson

Following the enactment of Section 302 of the Sarbanes-Oxley Act in 2002, the Securities and Exchange Commission (SEC) implemented rules requiring principal executive officers and financial officers of public companies to certify to the truthfulness of their company's quarterly and annual reports.<sup>1</sup> After this requirement went into effect, plaintiffs in securities litigation have attempted to use evidence of corporate officers' Sarbanes-Oxley (SOX) certifications to satisfy the requirement of pleading scienter for claims under Section 10(b) of the Securities Exchange Act. Consequently, courts have grappled with the issue of whether SOX certifications may be used for this pleading purpose by plaintiffs in securities fraud litigation. This article discusses how courts have split on this issue.

### Most Courts Reject Drawing an Inference of Scienter

Several courts have firmly rejected attempts by plaintiffs to plead an inference of scienter based on SOX certifications. For example, in *Garfield v. NDC Health Corp.*,<sup>2</sup> the Eleventh Circuit rejected the argument that SOX certifications by senior executives were sufficient to plead a strong inference of scienter. In *Garfield*, the plaintiffs filed a Section 10(b) action against NDC and several of its officers alleging that NDC "violated GAAP [generally accepted accounting principles], misstated the value of a failed investment and engaged in channel stuffing."<sup>3</sup> The district court dismissed the complaint on grounds that the plaintiffs failed to plead scienter adequately. On appeal, the plaintiffs argued that the personal SOX certifications that had been signed by company executives were "indicia of Defendants' scienter."<sup>4</sup> The Eleventh Circuit rejected this argument, however, concluding that the Sarbanes-Oxley Act does not indicate any intent to provide assistance to satisfying the pleading requirements for scienter under Section 10(b), including the heightened pleading requirements set forth in the Private Securities Law Reform Act (PSLRA).<sup>5</sup> The court explained, "If we were to accept [plaintiff's] proffered interpretation of Sarbanes-Oxley, scienter would be established in every case where there was an accounting error or auditing mistake by a publicly traded company, thereby eviscerating the pleading requirements for scienter set forth in the PSLRA."<sup>6</sup> The court held that SOX certifications are probative of scienter only "if the person signing the certification was severely reckless in certifying the accuracy of the financial statements."<sup>7</sup> The court further held that

this requirement cannot be met unless the person making the SOX certification had reason to know, "due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions."<sup>8</sup> The court found no such red flags in the case before it and thus affirmed the district court's dismissal of the complaint for failure to plead a strong inference of scienter.<sup>9</sup>

Similarly, in *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*,<sup>10</sup> the Fifth Circuit rejected the argument that SOX certifications were sufficient to establish a strong inference of scienter. In *Central Laborers' Pension Fund*, the plaintiffs filed a Section 10(b) action alleging that a company made a number of false or misleading statements regarding the company's financial condition.<sup>11</sup> The plaintiffs claimed that SOX certifications signed by the defendants and attached to the company's 10-K were indicative of scienter.<sup>12</sup> In analyzing whether the plaintiffs had adequately alleged scienter, the Fifth Circuit applied the Supreme Court's recent decision in *Tellabs v. Makor Issues & Rights, Ltd.*,<sup>13</sup> which held that a securities 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."<sup>14</sup> The Fifth Circuit accepted the Eleventh Circuit's decision in *Garfield* as a "plausible" interpretation of the Sarbanes-Oxley Act and held that because the plaintiff did not clearly explain the link between the SOX certifications and the actual accounting problems that arose, the SOX certifications did not permit an inference of scienter.<sup>15</sup> Thus, the Fifth Circuit upheld the district court's dismissal of the complaint.

Several district courts have reached the same conclusion as the Eleventh and Fifth Circuits. In *In re Watchguard Securities Litigation*,<sup>16</sup> the plaintiffs alleged that the defendant company misrepresented revenue-related information. The plaintiffs argued that the officer defendants' SOX certifications demonstrated scienter because the defendants either knew about the company's revenue recognition problems as a result of the accounting controls that they certified were in existence or were "deliberately reckless in not obtaining the information or conducting the investigations described in their certifications prior to publishing the false financial statements."<sup>17</sup> The Western District of Washington dismissed the plaintiffs' complaint, holding that the SOX certifications alone were inadequate to support a strong inference of scienter.<sup>18</sup> The court also noted that the Sarbanes-Oxley Act did not "transform the PSLRA's requirement of falsity-plus-scienter into a requirement of

falsity-plus-a-Sarbanes-Oxley-certification.”<sup>19</sup>

More recently, in *In re BearingPoint, Inc. Securities Litigation*,<sup>20</sup> the plaintiffs alleged that the defendants published false financial information despite knowledge of “lax internal controls” and “dysfunctional accounting systems” and made a series of misrepresentations and omissions regarding the timing and magnitude of a goodwill impairment charge.<sup>21</sup> The plaintiffs argued that scienter could be inferred from the CEO’s and CFO’s SOX certifications attesting to the accuracy of the financial information in the SEC filings.<sup>22</sup> The Eastern District of Virginia noted that under *Tellabs*, “the inference of scienter must be more than merely ‘reasonable’ or ‘permissible’—it must be cogent and compelling, thus strong in light of other explanations.”<sup>23</sup> The court then held that because the complaint failed to allege facts showing that the defendants knew or should have known that the relevant SEC filings were erroneous, “the mere act of signing SOX Certifications does not suggest culpability . . . [n]or do the errors in the filings suggest ‘glaring accounting irregularities’ or ‘other red flags’ that [the defendants] should have heeded.”<sup>24</sup> As a result, the court dismissed the complaint against the individual defendants for failure to adequately plead scienter.<sup>25</sup>

Similarly, in *In re Intelligroup Securities Litigation*,<sup>26</sup> the plaintiffs alleged that the company’s financial statements contained a host of accounting errors. The plaintiffs argued that the SOX certifications signed by the defendants “strongly suggest[ed] that Intelligroup’s financials were knowingly or recklessly misstated.”<sup>27</sup> The District of New Jersey rejected this argument, holding that erroneous SOX certifications do not give rise to a strong inference of scienter “unless the complaint asserts facts indicating that, at the time of certification, defendants knew or consciously avoided any meaningful exposure to the information that was rendering their SOX certification erroneous.”<sup>28</sup> The court found that, in this case, the plaintiffs did not allege a single fact indicating that the defendants had personal knowledge about the errors made in the statements or that the defendants were aware of any signs of wrongdoing, and the court therefore concluded that plaintiffs had not raised an inference of scienter based on the SOX certifications.<sup>29</sup> The court specifically noted that its holding is in accord with the Supreme Court’s teachings in *Tellabs*, that the facts alleged “must be cogent and compelling, thus strong in light of other explanations. A Complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as an opposing inference one could draw from the facts alleged.”<sup>30</sup>

### Some Courts Do Allow an Inference of Scienter

A few district courts have found that SOX certifica-

tions supported an inference of scienter. In *In re Lattice Semiconductor Corp. Securities Litigation*,<sup>31</sup> the plaintiffs brought a Section 10(b) action alleging that Lattice manipulated its financial statements by prematurely recognizing revenues on products that had been shipped to distributors but never sold to end users. The plaintiffs contended that the SOX certifications signed by the defendants gave rise to an inference of “at least deliberate recklessness.”<sup>32</sup> The District of Oregon held that the SOX certifications that were signed by company officers, in combination with allegations by the plaintiffs that the defendants attended regular finance meetings, received periodic and special reports, and were “micro-managers,” were sufficient to create a strong inference of scienter.<sup>33</sup> The court concluded that the SOX certifications gave rise to an inference of scienter because they provided evidence that the defendants either knew about the improper journal entries and unreported sales credits that led to the overreporting of revenues (because of the internal controls they said existed) or knew that the controls they attested to were inadequate.<sup>34</sup>

In *Croker v. Carrier Access Corp.*,<sup>35</sup> the plaintiffs alleged that Carrier overstated earnings and failed to disclose facts regarding its ability to profitably sell its products. The defendants argued that their SOX certifications had no bearing on their scienter.<sup>36</sup> The court rejected this argument and held that the SOX certifications “constitute one factor among many that courts may consider, in the totality of the circumstances, to evaluate scienter.”<sup>37</sup> The court found that the SOX certificates signed by the defendants, together with the defendants’ positions of authority, the magnitude of the company’s misstatement, and the defendants’ alleged motive and opportunity gave rise to a strong inference of scienter.<sup>38</sup>

Although the courts remain split over this issue, a majority, including all those that have addressed the issue at the court of appeals level, have determined that inferences of scienter may not be drawn from SOX certifications, at least absent red flags that show that the certifications regarding internal controls were knowingly false at the time they were made. Nonetheless, until all the courts of appeals and possibly the Supreme Court definitively resolve this issue, plaintiffs attempting to plead Section 10(b) claims likely will continue to attempt to cite SOX certifications as evidence giving rise to an inference of defendants’ scienter. ✱

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1. 15 U.S.C. § 78m, 78o(d); 17 C.F.R. § 240.13a-14(b)(2).
  2. *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006).
  3. *Id.* at 1260.
  4. *Id.* at 1265.
  5. *Id.* at 1266.
  6. *Id.*
  7. *Id.*
  8. *Id.*
  9. *Id.* at 1267.
  10. *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546 (5th Cir. 2007).
  11. *Id.* at 549.
  12. *Id.* at 554.
  13. *Tellabs v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).
  14. *Id.* at 2510.
  15. *Garfield*, 497 F.3d at 555.
  16. *In re Watchguard Sec. Litig.*, 2006 WL 2038656 (W.D. Wash. Apr. 21, 2006).
  17. *Id.* at \*9.
  18. *Id.* at \*11.
  19. *Id.*
  20. *In re BearingPoint, Inc. Sec. Litig.*, 2007 WL 2713906 (E.D. Va. 2007).
  21. *Id.* at \*1.
  22. *Id.* at \*11.
  23. *Id.* (quoting *Tellabs*, 127 S. Ct. at 2510 (2007)).
  24. *In re Bearing Point*, 2007 WL 2713906 at \*12.
  25. *Id.* at \*12.
  26. *In re Intelligroup Sec. Litig.*, 2007 WL 3376743 (D.N.J. 2007).
  27. *Id.* at \*67.
  28. *Id.* at \*70.
  29. *Id.* at \*71.
  30. *Id.* (quoting *Tellabs*, 127 S. Ct. at 2510 (2007)).
  31. *In re Lattice Semiconductor Corp. Sec. Litig.*, 2006 WL 538756 (D. Or. 2006).
  32. *Id.* at \*17.
  33. *Id.* at \*18.
  34. *Id.*
  35. *Croker v. Carrier Access Corp.*, 2006 WL 2035366 (D. Colo. 2006).
  36. *Id.* at \*11.
  37. *Id.*
  38. *Id.* at \*10.