

**BAILEY CAVALIERI LLC**  
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422  
telephone 614.221.3155 facsimile 614.221.0479  
[www.baileycavalieri.com](http://www.baileycavalieri.com)

**CEO/CFO CERTIFICATIONS: SEPARATING MYTH FROM  
REALITY**

**Prepared by**  
**Dan A. Bailey**  
**J. David Washburn**  
**Quentin C. Faust**

*The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.*

In the wake of recent financial and accounting scandals that have left the public skeptical and investors apprehensive about the accuracy and completeness of corporate financial statements, the Securities and Exchange Commission (“SEC”) is attempting to bolster confidence in those statements by requiring corporate officers to either certify the accuracy and completeness of their SEC financial filings or explain any inaccuracies. On June 27, 2002, the SEC issued Commission Order No. 4-460 (the “Order”), which imposes a one-time certification requirement. A few days earlier, the SEC proposed a permanent regulation that would create an ongoing certification requirement (the “Proposed Rules”)<sup>1</sup>. This memorandum is intended to describe both the Order and the Proposed Rules, as well as explain the likely consequences of these new requirements.

## **Q1. Who will the Order and Proposed Rules effect?**

- A.** The Order applies to certain publicly traded companies with revenues during their last fiscal year of greater than \$1.2 billion. There are currently 947 companies on a list maintained by the SEC that are covered by the Order. This list may be found at <http://www.sec.gov/rules/other/4-460list.htm>.

On the other hand, the Proposed Rules do not distinguish between large and small companies, but instead would apply to all publicly-held companies that file reports with the SEC under Section 13(a) or 15(d) of the Securities Exchange Act (the “Exchange Act”). Foreign private issuers subject to the Exchange Act reporting requirements would not be subject to the Proposed Rules.

## **Q2. What does the Order require?**

- A.** The Order requires the principal executive officer (for the purposes of this article, the “CEO”) and principal financial officer (for the purposes of this article, the “CFO”) to provide:
- A certification, in writing, under oath, that to the best of his or her knowledge the information contained in the company's most recently filed Annual Report on Form 10-K (“10-K”) and each subsequently filed Quarterly Report on Form 10-Q (“10-Q”), Current Report on Form 8-K (“8-K”) and/or definitive proxy statement (the “Proxy”) for the company’s current reporting year is correct and complete as of end of the period covered by the 10-K or 10-Q, or the date of filing of the 8-K or Proxy (a copy of the form provided by the SEC may be found at <http://www.sec.gov/rules/other/4-460a.htm>); or
  - A statement, in writing, under oath, describing the facts and circumstances that would make such a certification incorrect.

The Order also requires a declaration in writing, under oath, whether or not the contents of the statement have been reviewed with the Company's audit committee or, in the absence of an audit committee, the independent members of the Company's board of

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<sup>1</sup> See SEC Release No. 34-46079. The New York Stock Exchange and NASDAQ have proposed comparable certification requirements for companies listed on those exchanges.

directors. Because the Order applies only to SEC filings in the company's current fiscal year, the Order effectively terminates as of the beginning of the company's 2003 reporting year.

**Q3. What do the Proposed Rules require?**

A. The Proposed Rules would impose a permanent requirement that the CEO and CFO certify in each annual report that:

- He or she has read the report;
- To his or her knowledge, the information in the report is true in all important respects as of the end of the period covered by the report; and
- The report contains all information about the company of which he or she is aware that he or she believes is "important to a reasonable investor" as of the end of the period covered by the report.

As defined in the Proposed Rules, information is "important to a reasonable investor" if:

- There is a substantial likelihood that a reasonable investor would view the information as significantly altering the total mix of information in the report; and
- The report would be misleading to a reasonable investor if the information was omitted from the report.

A similar certification would be required for quarterly reports, but would be modified to account for the narrower disclosure requirements for quarterly reports. The text of the certification for both annual and quarterly reports may be found at <http://www.sec.gov/rules/proposed/34-46079.htm>.

Additionally, the Proposed Rules would require every company subject to the reporting requirements of the Exchange Act to:

- Maintain sufficient procedures to reasonably assure that the company is able to collect, process and disclose, within the time periods specified in the rules and forms, the information required to be disclosed in its periodic and current reports filed pursuant to the Exchange Act (the "Procedures");
- Evaluate the effectiveness of the Procedures before the filing of its annual report (the "Evaluation"); and
- Ensure that those conducting the Evaluation communicate the results of the Evaluation to the CEO, CFO and board of directors.

Finally, under the Proposed Rules the CEO and CFO would have to separately certify that they have reviewed the results of the Evaluation.

**Q4. The Order requires the certification to be “to the best of my knowledge,” while the Proposed Rules require certification to be “to my knowledge.” What’s the difference?**

The SEC has not expressly stated whether it intended to make a distinction between “to the best of my knowledge” and “to my knowledge.” Arguably, “to the best of my knowledge” imposes a due diligence requirement, and “to my knowledge” does not. However, in examining the form of certification provided by the SEC for the Order and the statement of purpose accompanying the Proposed Rules, the SEC appears to be focusing on only the actual knowledge of the CEO and CFO and not requiring separate inquiries by the CEO and CFO as to information not known to him or her. Although the Order and the Proposed Rules may not create additional investigatory requirements on the CEO and CFO, current law already requires reasonable diligence by senior officers regarding the preparation of disclosure documents.

**Q5. When do the certifications need to be made?**

- A. Under the Order, the CEO and CFO's certifications must be made no later than the first day on or after August 14, 2002 on which the company must file an annual or quarterly report for its current reporting year. If a company has already filed an annual or quarterly report for its current reporting year, certifications for those prior filings will be due by August 14, 2002.

Under the Proposed Rules, CEO and CFO certifications will be made when a company files any annual or quarterly report with the SEC. Certifications do not need to be made with an 8-K or Proxy.

**Q6. Will certification increase the signing executives' liability?**

- A. The SEC has stated it does not believe any increased liability will result for CEOs and CFOs making certifications under the new rules. Technically, that conclusion is probably correct in light of existing law, although a knowingly false certification under oath may increase one’s exposure to criminal prosecution.

The certifications by the CEO and CFO may have a psychological impact on a court or jury, though, since the certifications are a more direct and public affirmation of accuracy than the legal duty imposed by law. In any event, the existence of the certification can only aggravate an already dangerous litigation environment for senior officers.

**Q7. What effect will certification have on D&O Liability Insurance?**

- A. The certification requirements under the Order and Proposed Rules should not *per se* create any new issues or concerns under standard D&O liability insurance policies. Although loss arising from a false certification may not be covered if, for example, the deliberate fraud or the fine or penalty exclusions are applicable, the mere existence of the Order and Proposed Rules should not create D&O insurance issues which now need to be addressed. For example:

- By signing the certifications, the CEO and CFO should be acting in an insured capacity;
- The certifications should not *per se* constitute warranties by the officers to the D&O insurer which could constitute a basis for rescission of the policy by the insurer if the certification is false;
- The Order should not constitute a “demand or order” which could either constitute a Claim or potential Claim under the insurance policy or which could implicate the “pending or prior litigation” exclusion.

The requirement in the Proposed Rules which requires a company to maintain procedures to help assure the accurate preparation of SEC filings and to annually evaluate the effectiveness of those procedures may become a focus of D&O insurance underwriters. For example, underwriters may begin to request copies of those procedures and annual evaluations as part of the D&O insurance policy underwriting analysis. In addition, some insurers may add to the insurance policy an exclusion for claims relating to the failure by the CEO or CFO to sign the required certifications since insurers may want to avoid any attempt by the CEO or CFO to sidestep the certification requirements at the expense of the insurance coverage.

**Q8. How can CEOs and CFOs minimize exposure under the Order and the Proposed Rules?**

- A.** If not already in place, the CEO and CFO should implement a comprehensive process to demonstrate reasonable diligence in the preparation of SEC filings and other public disclosures. For example, a timeline of necessary actions and expressed delegation of specific tasks and responsibilities should be clearly identified and understood by all persons involved in the process. Also, management should be certain that adequate internal and external resources are devoted to the process and that the persons involved have full and unrestricted access to all company records, information and personnel.

From a personal standpoint, the CEO and CFO should assure themselves that:

- the internal audit process is both adequately designed, empowered, supported and implemented;
- the outside auditors have full access to necessary information and are demonstrating sufficient diligence, independence and a commitment to conservative accounting practices; and
- the audit committee of the Board of Directors is financially literate, truly independent and sufficiently probing of management and outside auditors.

Ultimately, the CEO and CFO are not guarantors of the accuracy of the SEC filings. Instead, senior executives are expected to perform reasonable diligence in assuring themselves that the filings convey an accurate summary of the company and its financial performance and condition. The more complete and documented a company’s processes

for verifying the accuracy and completeness of the filings, the more comfortable senior officers can feel regarding their potential liability exposure.