SEC Charges Corporate Officers with Fraud Arising from Failure to Disclose Internal Controls Issues and Alleged Misrepresentations in SOX Certifications

On July 30, 2014, the Securities and Exchange Commission ("SEC") advanced a novel theory of fraud against the former CEO (Marc Sherman) and CFO (Edward Cummings) of Quality Services Group, Inc. ("QSGI"), a Florida-based computer equipment company that filed for bankruptcy in 2009. The SEC alleged that the CEO misrepresented the extent of his involvement in evaluating internal controls and that the CEO and CFO knew of significant internal controls issues with the company's inventory practices that they failed to disclose to investors and internal auditors. This case did not involve any restatement of financial statements or allegations of accounting fraud, merely disclosure issues around internal controls and involvement in a review of the same by senior management. The SEC's approach has the potential to broaden practical exposure to liability for corporate officers who sign financial statements and certifications required under Section 302 of the Sarbanes-Oxley Act ("SOX"). By advancing a theory of fraud premised on internal controls issues without establishing an actionable accounting misstatement, the SEC is continuing to demonstrate that it will extend the range of conduct for which it has historically pursued fraud claims against corporate officers.

To establish an actionable misstatement, the SEC asserted that Mr. Sherman and Mr. Cummings (1) signed Form 10-Ks with false management reports on internal controls and (2) signed SOX certifications in which they falsely represented that they had evaluated the management report on internal controls and disclosed all significant deficiencies to auditors. The SEC took the position that the Form 10-K SOX management reports were false because they contained assertions that management, with the participation of Mr. Sherman and Mr. Cummings, evaluated internal controls using a specified framework, but the SEC asserted that Mr. Sherman did not participate and was unfamiliar with the referenced framework. The SEC also viewed the SOX certifications as false because two internal controls issues of which Mr. Sherman and Mr. Cummings were aware were not reported to the company's external auditors:

- The SEC alleged that QSGI's inventory controls at its Minnesota facility were insufficient, resulting in inaccurate inventory counts as product moved into and out of the facility without appropriate entries in the company's books and records. The SEC attributed the cause of such issues to (1) a general practice of removing component parts from products in inventory without documenting it; (2) inexperienced accounting personnel who were afforded autonomy; and (3) failed efforts to introduce new controls. The SEC further asserted that Mr. Sherman and Mr. Cummings were aware of failed efforts to implement new controls when they signed fiscal year QSGI's 2008 financial statement certifications.
- The SEC also alleged that Mr. Sherman and Mr. Cummings accelerated recognition of accounts receivable and/or the receipt of product into inventory by a matter of days up to approximately a week. The SEC stated that the acceleration occurred to maximize QSGI's potential borrowing base on a working capital loan with the company's chief creditor. These activities, however, did not appear to violate accounting rules such that a restatement of financials would be required.

As a result of the aforementioned allegations, the SEC announced charges against Mr. Sherman and Mr. Cummings for, among other things, violations of Section 10(b) and Section 13(b)(5) of the Securities Exchange Act of 1934 and for causing QSGI to violate of Section 13(b)(2) of the same. Section 10(b) prohibits the "use of any device, scheme, or artifice to defraud" in connection with the purchase or sale of a security. Section 13(b)(5) forbids knowing falsification of a public company's books and records or knowing circumvention of a public company's internal controls. Section 13(b)(2) requires public companies to make and keep accurate books and to devise and maintain effective internal accounting controls. Mr. Cummings entered into a settlement without admitting or denying the SEC's claims, resulting in a $23,000 civil monetary penalty and a minimum five-year bar from appearing in front of the SEC as an accountant as well as a five-year bar from acting as an officer or director of a public company. Mr. Sherman has not settled his claims and will be required to appear at an evidentiary hearing before an Administrative Law Judge to contest the SEC's allegations.

In its press release announcing the charges, the SEC took the opportunity to state that corporate executives have "an obligation to take the Sarbanes-Oxley disclosure and certification requirements very seriously." It is also clear that, where appropriate, management needs to be open with its auditors about internal controls issues. We believe that transparency with the company's audit committee and external auditors regarding evaluations of the company's internal controls will protect the company, its investors and its officers. Additionally, it may be appropriate for a company's CEO and CFO to revisit their company's internal controls review framework as well as their individual involvement in the same.

Finally, this case, which includes fraud charges in an accounting case without any restatement of financials, seems to represent an application of SEC's "Broken Windows" strategy first announced by Robert Khuzami and reiterated by Mary Jo White – to pursue small infractions on the theory that minor violations lead to larger ones – to the public company disclosure and accounting space.

R. Daniel O'Connor
Marko S. Zatylny
Kait Michaud
Michael J. Vito