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Verisign Fraud - Class Action Lawsuit

Background
United States district court, northern district of California was the start of Verisign's ("the Company") class action complaint for a violation of securities laws. Plaintiff, James H. Harrison Jr., on behalf of himself and all others similarly situated filed vs. Verisign, Inc., Stratton D. Sclavos, Robert J. Korzeniewski, Dana L. Evan and Quintin P. Gallivan. The "class" period is for people who purchased shares of the company between January 25 and April 25 2002.

The defendant Verisign is headquartered in Mountain View California and offers users the ability to engage in secure digital commerce and communications. Verisign's stock is traded on the NASDQ national market.

Allegations
The allegation is that the defendants tried to artificially increase the Company's revenue and create the perception that its deferred revenue was being generated organically rather than through acquisition. It is claimed that the Company derived a portion of its revenue from non-monetary barter transactions and investments in other companies. The later claim stated simply, they were financing the payments they were receiving for their goods and services.

The complaint states that the revenues were dubious at best and claimed that "whenever a two-way set of transactions occurs in which a company acts as the lender and service provider, an investor lacks assurance as to whether the related parties would have made a similar decision regarding purchases in the absence of financing from the company". They claimed that because of this it was not possible to get an accurate measure of the real demand for Verisign's products.

The complaint also alleges that the defendants misrepresented the company's prospects and failed to properly disclose improper acts until they were able to sell at least $26 million of their own stock, and also to buy companies in stock-for-stock transactions. Verisign violated Generally Accepted Accounting Principles and Securities Exchange rules by engaging in improper barter transactions. These activities dramatically overstated the company's margins in its financial statements.

The final complaint states that in addition to the above activities, the defendants had other material information that they concealed from the plaintiffs. The defendants concealed an acquisition because they wanted the public to get the impression that the company's revenue growth was organic when in fact it was not. Statements were made concerning the company's ability to grow its operating margins that were "simply impossible". The integration of two acquisitions was a disaster and clients began to decline rather than grow as the defendants had stated. Other information that was withheld by the defendants included; quickly losing market share to the competitors because of outrageous prices, the company's web certificate business would post zero growth for the year, the ESP

division would post zero organic growth and the fact that 100% of the growth was from acquisitions, the domain name business was losing customers at the rate of 11,000 per day, contrary to statements made by the defendants recent acquisitions would cost $80 million more than expected, receivables were dubious and allowance for doubtful accounts had increased five times over the prior period and lastly the company manipulated its Days Sales Outstanding to paint a rosier picture.

Issues

Plaintiffs argue five key categories of misrepresentations:

1. Defendants inflated accounts receivable, revenue and deferred revenue by improperly accounting for two-year auto-renewals on domain names, and acquired deferred revenue.
2. Defendants used improper accounting to recognize revenue on roundtrip and barter transactions.
3. Defendants failed to adequately reserve for uncollectible delinquent receivables thereby overstating earnings.
4. Defendants misreported domain name registrations by concealing the number of free and promotional registrations and two-year auto-renewal registrations.
5. Defendants overstated earnings by failing to properly account for long-term investments in non-public companies and by failing to record impairment charges on many investments.

Specifically, Plaintiffs contend that VeriSign recognized $27 million in barter transactions, $10.5 million in reciprocal transactions, $64 million by roundtrip transactions and $12 million by improper accounting practices. Plaintiffs further allege that VeriSign failed to follow GAAP in terms of recording a $74 million impairment charge.

Defendants argue that companies regularly disclose their true financial condition and their stock price declines when they fail to meet the market expectations. Defendants further argue that Plaintiffs fail to allege that April 25, 2002 disclosure was responsible for the decline in stock price or revelation of any fraud by the company. The disclosure that causes the stock price to decline must be the subject matter of the misstatements or omissions that are the basis for plaintiffs' securities fraud claims.

The Defendants site Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627, 1634 (2005) as an example. The Court held, however, that the complaint failed to claim "that Dura's share price fell significantly after the truth became known," and thus failed to provide defendants with notice of the causal connection between any economic loss and the alleged misrepresentation.

In another example of Tellium Inc, where the company suddenly reveled in January 2002 that it needed new customers to achieve its $288 million revenue guidance even after repeated assurances about its sales commitments, the Defendants pointed out the following. The court held that these allegations did not plead loss causation because "[p]laintiffs have failed to allege that the concealed scheme was ever disclosed to the market, thereby affecting the price of Tellium's stock."

Based on Plaintiffs inability to allege a causal connection between the alleged fraud and their alleged losses, the Defendants appealed that their motion should be granted.
The courts found that the Plaintiffs have pled loss causation only with respect to the first category of fraud, namely, improper revenue recognition and misstatements of reciprocal and related party transactions. Hence the Plaintiffs continued to plead through future amendments trying to establish loss causation. On the contrary, the Defendants argued motion to dismiss on the pretext that the Plaintiffs were unable to establish loss causation by repeatedly stating that even though the market was unaware of the fraudulent scheme, April 25, 2002 disclosure was responsible for the price decline.

Court's Findings
Rule 10b-5 Claims
The court applies this rule that investors have a right to action if the company uses materially false or misleading statements that leads to harm of those who buy or sell that particular security. The claim must state a material representation, scienter, a purchase or sale of the security related to that representation, reliance on the information, and a loss caused by that reliance. In this case the "defendants do not challenge that the misstatements or omissions were made in connection with the purchase, reliance on those misstatements or omissions or that they suffered an economic loss." Along with the 10b-5 requirements, securities fraud allegations must adhere to Rule 9(b) of the Federal Rules of Civil Procedure (In re Advanta, 180 F.3d at 531) of "(1) a specific false representation of material fact, (2) knowledge by person who made it that it was false, (3) ignorance of its falsity, (4) intention that it should be acted on, and (5) that plaintiffs action upon it to his damage." Therefore, the court must decide on materiality, misrepresentations or omissions, scienter, and the loss causation.

Materiality
Both the parties rely on Oran v. Stafford, 226 F.3d at 282 that for a fact to be material the disclosure of bad news must cause a decline in stock price. The court ruled that although there was not an immediate decline in stock price since from the partial disclosures that he negative information could have been displaced by what the market appeared as good news. Defendants held that Ieradi v. Mylan Lab 230 F.3d 594 ruling of the initial disclosure would be sufficient and following admissions would be insignificant in the total mix of information available. The court disagrees because in this case the market hardly reacted to the news of MedQuist possible delisting and the stock price actually increased until they were actually de-listed. The threat of the delisting was unimportant to the market and although the risk was disclosed it was not materialized until it significantly altered the mix of information. Since also the disclosures were a series of partial information and the actual over billings were substantially larger then disclosed estimates there is not a "reliable benchmark with which to conclude that the earlier financial misstatements were immaterial. (Burlington, 114 F.3d at 1425)"

Misrepresentations or Omissions
The plaintiffs allegations of several misstatements/omissions through 15 press releases, 4 annual reports, 12 quarterly reports, and many conference calls led to defendants arguing that there is no Section 10(b) liability as a matter of law "isolated statements of factual

revenues allegedly generated by improper activities led to no duty to disclose and thus do not give rise to Section 10(b) liability (Convergent Tech. Sec. Litig., 948 F.2d 507, 512-12)." Using In re Par Pharm., Inc. Sec. Litig., 733 F. Supp. 668, the courts ruled that the obligation of executives is to speak the true in disclosures and make additional comments when there is a chance of making prior statements misleading. The court found that the plaintiffs' complaint sufficiently illustrates "how the scheme was devised, who (did) it, and how it was implemented." Coupled with the Board of Directors admission to not rely on prior financial statements during 2002-2003, it is clear that the defendant made statements during the class period deemed false or misleading.

Scienter

The court uses GSC Partners CDO Fund v. Washington, 368 F.3d 228, 237 to determine that scienter may be established in one of two ways: "(1) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (2) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Further clarification is provided from In re Supremea, 438 F.3d at 277 that insider stock sales are not inferred to be motive unless the sale is done in a means that is unusual in the scope or time of the action. The factors that are considered include the profit, the number of shards, % ownership or number of people involved on the inside (Wilson v. Bernstock, 195 F. Supp. 2d 619, 635). The plaintiffs' complaints allege that CTO Ethan Cohen, COO Donohoe, and CEO David Cohen had created the technology to over bill customers, used undocumented invoices to eliminate customer's ability to verify the accuracy, and even bragged about their billing scheme to other managers about the increased billing they'd mastermind. Based on these facts the court found that since they were in controlling positions of the company they had direct knowledge of the fraud scheme at the time of the false statements therefore the plaintiffs have properly pleaded scienter.

Loss Causation

According to Lentell, 396 F.3d at 173 "holding loss causation will be established if (the) relationship between plaintiff's investment los and information concealed by defendant is sufficiently direct." In addition, Newton, 259 F.2d at 172 states that plaintiffs must also establish transaction causation; "establishes that but for the fraudulent misrepresentation the investor would not have purchased or sold the security." Defendants do not argue the transaction causation but do argue that the delisting disclosure was not related to the billing scheme thus there was no way to prove causation of that disclosure to the fraudulent loss. The court ruled that the press release of the delisting was directly related to the fraud because it was leading to the investigation into the company's fraudulent billing scheme therefore the plaintiffs have "properly pleaded loss causation"

Additional Facts

Section 20(a) claims against the individual defendants were found to be convincing that "control persons" were reasonably accountable for the losses. Also, the accounting firms were not held responsible because the plaintiffs failed to prove KPMG & Arthur Anderson had seen the false documents, whether the documents alone would suffice to knowledge of fraud and they admitted that the billing scheme was based on secret coding

that had left no clear paper trail. After all these findings Versign decided to settle the case outside of court and the decision was approved.

Opinions Regarding Courts Decision

We felt that the court came to the proper decision in this case as there was clearly an egregious bill fraud scheme that was being covered up with an argument that said the stock price change was related to the delisting news. The defendants could not prove that the delisting was unrelated to the billing scheme as it clearly was the source of the problems. The general disregard that management held towards disclosing their scheme at company conferences is outrageous and should not be treated lightly. The only issue we had with the decision with the settlement is that the executives were not held personally responsible for their deception. Settlement only cost those remaining shareholders that were not a part of the lawsuit. Criminal charges against the executives would be justified and warranted by these actions.

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