

Corporate & Financial Weekly Digest

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Improper Accounting Adjustments Held Insufficient Basis for Securities Fraud Claims

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A federal district court in California recently dismissed class action securities fraud claims arising out of several improper accounting adjustments made by VeriFone Holdings, Inc. On September 15, 2010, purchasers of VeriFone common stock filed their Third Amended Complaint in a consolidated securities fraud class action against the corporation and certain of its officers and directors. Plaintiffs alleged that defendants violated Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 by engaging in a scheme to defraud, making false statements, omitting material facts and performing deceptive acts which led to the gross overstatement of operating income and, ultimately, the restatement of VeriFone's financials. Defendants moved to dismiss, arguing, among other things, that that plaintiffs did not adequately allege scienter as to each individual or the corporation.

The restatement was necessitated by a series of accounting errors made by Paul Periolat, VeriFone's supply chain controller. In particular, after receiving internal preliminary financial results that were below the company's forecasts, VeriFone's chief executives demanded that management figure out what had happened. In response, Mr. Periolat determined, incorrectly, that the company was not accounting for its inventory properly and made several manual adjustments to the financial results that inflated VeriFone's earnings. Mr. Periolat acted without having the adjustments scrutinized or approved by more senior VeriFone management. Thus, Mr. Periolat manually adjusted the amount of inventory held by a foreign subsidiary, without speaking with the foreign subsidiary's controller and despite knowing that the subsidiary had proper procedures in place for accounting for inventory.

The district court held that Mr. Periolat's faulty accounting adjustments may have been grossly negligent, but did not support a strong inference that Mr. Periolat or VeriFone acted with scienter. Although the court determined that the allegations of scienter were "cogent," it held that other, non-fraudulent inferences were more compelling. In particular, because the adjustments Mr. Periolat made were not concealed in any way and Mr. Periolat's previous projections were accurate, the court determined that the most likely explanation for Mr. Periolat's actions was that he believed his adjustments were correct. (*In re VeriFone Holdings, Inc. Securities Litigation*, 2011 WL 843959 (N.D.Cal. March 8, 2011))

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