EXPANDING CHIEF OFFICERS' LIABILITY AND THE PROMISE TO RAISE INVESTOR CONFIDENCE[*]

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I. INTRODUCTION

Michael G. Oxley first introduced the now deemed Sarbanes-Oxley Act in the House of Representatives on February 14, 2002.[1] After two months of going through committees and amendments, the bill passed the House to the Senate on April 24, 2002.[2] On July 30, 2002, President George W. Bush signed this bill into law.[3] Part of the new legislation is the requirement that principal executive officers and principal financial officers sign an oath verifying that the reported financial statements for the

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1. H.R. 3763, 107th Cong. (2001).
2. *Id*.
3. *Id*.

corporation are correct.[4] This comment will review the theories and cases where officers were held liable and cases where they were not. Then the comment will discuss the significant changes in the capital markets and the world that led up to the creation of the Sarbanes-Oxley Act. It will discuss and analyze what the Act states and what it purports to do. The comment will also analyze the effects of the Act on future litigation, corporate policies and on other aspects of the market. Finally, the comment will discuss whether the Act will live up to its expectations and result in an increase in investor confidence.

Over the last couple of years, corporate America has moved from the financial section of the newspaper to the front page.[5] The accounting fraud unveiled at Enron was so massive that it brought down one of the largest companies in the country.[6] The saga continued when Arthur Anderson was alleged to have obstructed justice.[7] Suddenly, major companies were being investigated, such as WorldCom, Adelphia, G.E., ImClone, Tyco and Xerox.[8] Corporate executives were the main targets of many of these investigations. Author Matt Murray chronicled the ongoing fiasco regarding G.E.'s CEO Jack Welch.[9] The SEC looked at three areas in its G.E. inquiry:

"[W]hether the original disclosure of the terms of Mr. Welch's perks in his 1996 contract was adequate; whether the company properly disclosed and accounted for Mr. Welch's perks while he was CEO; and whether it has properly disclosed and accounted for his benefits since he retired in September 2001."[10]

Under the original contract, Mr. Welch was paid a minimum of $86,000 per year for consulting and was guaranteed use of GE facilities and services "comparable to those provided him prior to his retirement, including access to company aircraft, cars, office, apartments and financial planning services."[11] Mr. Welch only had to pay personal income tax for all personal use of those facilities and services.[12] Because G.E. had never disclosed an

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4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745, 777–78 (2002), *available at* http://frwebgate.acess.gpo.gov/cgi-bin/useftp.cgi?Ipaddress=162.140.64.88&filename=publ204.pdf&directory=/diskc/wais/data/107_cong_public_laws.

5. Joseph E. Murphy, *Can the Scandals Teach Us Anything?*, BUS. LAW TODAY 11 (January/February 2003).

6. *Id.*

7. *Id.*

8. *Id.*

9. Matt Murray, *SEC Investigates GE's Retirement Deal with Jack Welch*, WALL ST. J., Sept. 17, 2002, at B1.

10. *Id.*

11. *Id.*

12. *Id.*

estimated cost of those items, many details were not clear until, Mr. Welch's wife, Jane, submitted her financial affidavit in court.[13] In that filing, she said G.E. paid many costs of the corporate apartment in Manhattan where Mr. Welch stays, "including flowers and groceries; provided tickets to major sporting events; and paid for country-club fees, security and financial planning, among other services."[14]

Another recent event that exemplified the waste that certain chief executive officers indulge in was reported in the *Houston Chronicle*. Tyco International said it uncovered nearly $100 million in fraudulent employee bonuses and revealed it picked up the tab for personal expenses, including a $2,200 wastebasket for indicted former Chairman Dennis Kozlowski's New York City apartment.[15] Tyco "accused Kozlowski of recklessly tapping company funds, including using more than $1 million in company funds for his wife's birthday party on the Italian island of Sardinia last year."[16] According to Tyco's filing, the event had gladiators and an ice sculpture of Michelangelo's David with vodka streaming from his penis into crystal glasses.[17] The SEC says Kozlowski, former Chief Financial Officer Mark Swartz and former general counsel Mark Belnick treated Tyco as their private bank, "taking out hundreds of millions of dollars of loans and compensation without ever telling investors."[18]

Despite the recent events shining light on officer misuse, officer liability has been contested in the judicial system for many years. Officer liability has been a part of state laws long before the federal securities law came into existence. The courts in each circuit and each state have differed on how to hold the officers liable. Therefore, according to Congress and the SEC, there has been a need for a uniform framework for holding chief officers liable.

II. OLDER CASES DEALING WITH PRINCIPAL OFFICER LIABILITY

In the 1891 case *Chittenden v. Thannhauser*, the New York Court of Appeals looked at a New York statute dealing with officer liability.[19] The statute required that if any certificate made

13. *Id.*
14. *Id.*
15. *Report Details Extravagance, Fraud at Tyco*, HOUS. CHRON., Sept. 18, 2002, at 1B.
16. *Id.*
17. *Id.*
18. *Id.*
19. 47 F. 410, 411 n.1 (C.C.S.D.N.Y. 1891).

by the officers of any company is false in any material representation, then all the officers who have signed the same, knowing it to be false, will be jointly and severally liable for all the debts the company contracted while they were officers of that company.[20] In this specific case, the officers and trustees of the defendant Cortes Company signed a certificate stating that the whole amount of the capital stock of the company, value of $1,500,000, had been issued as full-paid stock to William B. Hatch & Co. for the purchase of mines and other property.[21] Although the court found that the officers might not have meant to defraud anyone by stating in the certificate that the value was much higher than it actually was, the officers were held liable for debts contracted to the full amount of the capital stock.[22]

In 1979, a Court of Appeals in Kentucky granted summary judgment to the defendant corporate employee.[23] In this case, plaintiffs claimed that the defendant was liable for fraudulent statements made in a prospectus during a securities sale.[24] In the prospectus, the defendant's name appeared as though he were vice-president of the company.[25] Thus, the plaintiffs claimed that, as a chief officer of the corporation, the defendant employee should be held personally liable for failing to correct false and misleading statements in the documents.[26] The defendant's uncontradicted affidavit established that he had no connection with the allegations of securities fraud.[27] He also argued that his duties, training store managers and ordering food, in no way materially aided the sale of securities.[28] Thus, the court held that where an officer was not in a position to knowingly participate in any securities scheme, and where he did not materially aid any sale of securities as required of officers, that officer cannot be held liable.[29] The court also noted that "by no stretch of the imagination was [defendant] a 'controlling person' as defined by the Securities Acts."[30]

In *Meyers v. Moody*, the 5th Circuit Court of Appeals reviewed the Texas state law that imposes on corporate officers

20. *Id.*
21. *Id*. at 410.
22. *Id.* at 411.
23. Herm v. Stafford, 466 F. Supp. 439 (W.D. Ky. 1979).
24. *Id.* at 440.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. Herm v. Stafford, 466 F. Supp. 439, 440 (W.D. Ky. 1979).
30. *Id.*

and directors a duty to exercise due care in the management of the corporation's affairs.[31] In the lower court trial, the jury found that Moody, the defendant-officer, negligently managed the business affairs of and breached his fiduciary duties to the company.[32] The jury also found that Moody's behavior amounted to "intentional misconduct or gross negligence."[33] "The jury thus accepted the plaintiff's contention that Moody was at least grossly negligent in undertaking a massive acquisition program based on an artificially inflated surplus . . . ."[34] Once again, the court has found that where officers were knowingly involved in certain actions taken by the company, the officers will be held liable.

The District Court for the District of Massachusetts confronted the issue of holding corporate officers and sole shareholders personally liable for delinquent payments to an employee benefit retirement plan.[35] Defendants Jerome Danin and Frank Fredella were the two sole officers and shareholders of the corporation Vi-Mil.[36] Plaintiffs brought an action against these two individuals to hold them personally liable for the delinquent funds owed to the plaintiffs.[37] The plaintiffs argued that the defendants deliberately made the decision to continue their company's operations even though Vi-Mil faced serious financial difficulties.[38] The defendants also knowingly made the decision to pay back certain creditors and not pay others.[39] The plaintiffs fell within the category of the creditors that were not paid.[40] The following facts demonstrated that the defendants were personally liable for the delinquent payments to the plaintiffs:

> Danin and Fredella were each officers, employees, and fifty percent shareholders of Vi-Mil during the relevant period. Each was deeply involved in the day-to-day operations of the company, including negotiating collective bargaining agreements and dealing with the

31. 693 F.2d 1196, 1209 (5th Cir. 1982).
32. *Id.*
33. *Id.*
34. *Id.*
35. Trustees of Amalgamated Ins. Fund v. Danin, 648 F. Supp. 1142, 1143–44 (D. Mass. 1986).
36. *Id.* at 1144.
37. *Id.* at 1143.
38. *Id.* at 1144.
39. *Id.*
40. *Id.*

> plaintiffs. Their duties involved making payments to the plaintiffs by checks, which both defendants were required to sign. When Vi-Mil encountered financial adversity, the defendants decided to continue operations and determined which creditors to pay and which not to pay; in the process they decided that Vi-Mil would not make the payments to the plaintiffs which were at issue in this case.[41]

Under these circumstances, the court held that "the defendants were personally liable for the delinquent payments."[42]

In *In re Worlds of Wonder Securities Litigation*, a class of purchasers of a toy manufacturing corporation's debentures brought a securities fraud action under the Securities Act of 1933 and the Securities Exchange Act of 1934 against the defendant corporation's officers, directors, major shareholders, and independent auditor.[43] Regarding the liability of the officers, directors, and shareholders, the Ninth Circuit Court of Appeals held that they escaped liability.[44] Worlds of Wonder ("WOW"), the defendant corporation, had hired Deloitte & Touche ("Deloitte") to be the independent auditor for the company's financial statements and records.[45]

The plaintiffs filed this class action suit alleging securities fraud in connection with the debenture offering.[46] Although the court did not determine whether the statements in the financial statements were falsified because of the enormous amount of contradicting evidence given by both sides, the court did resolve the liability issue as to the officers, directors and shareholders.[47] "Because the audited financial statements were 'certified' by Deloitte . . ., every defendant other than the auditor [could] escape . . . liability for the statements by establishing that they 'had no reasonable ground to believe and did not believe . . . that the ['expertised'] statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.'"[48] In this case, the directors and shareholders were

41. Trustees of Amalgamated Ins. Fund v. Danin, 648 F. Supp. 1142, 1147 (D. Mass. 1986).
42. *Id.*
43. 35 F.3d 1407 (9th Cir. 1994).
44. *Id.* at 1421.
45. *Id.* at 1412.
46. *Id.*
47. *Id.* at 1421.
48. *Id.*

able to escape liability under the language of section 11 of 15 U.S.C. § 77k(b)(3)(C).[49] This case clearly exemplifies the situation where numerous officers have escaped liability by claiming that they had no knowledge of the untruthfulness of their company's financial statements. The Sarbanes-Oxley Act should prevent such evasion from liability by requiring that the officers swear to any published financial statements.

III. RECENT CASES DEALING WITH OFFICER LIABILITY

In *Paracor Finance, Inc. v. General Electric Capital Corp.*, plaintiffs were investors who purchased debentures as part of a leveraged buyout of the defendant corporation.[50] They brought an action against the corporation, the financer of the leveraged buyout, the purchaser of the corporation, the corporation's chief executive officer (CEO), and the corporation's president.[51] "The heart of [their] claim was that they were not provided with the negative sales data for the three months immediately prior to the closing."[52] With regard to General Electric Capital Corp. ("G.E. Capital"), the court found that "G.E. Capital could not be held liable for its alleged omissions because it never had a duty to disclose to the investors in the first place."[53] Ultimately, because of the lack of the duty to disclose, the Ninth Circuit Court of Appeals held that the corporation was not liable for any representation and the actions against the officers of the corporation were also dismissed.[54]

In *In re Scholastic Corp. Securities Litigation,* stockholders brought a securities fraud class action suit against a book publisher and one of its officers alleging that the defendants made materially false and misleading statements and concealed adverse figures, which caused the stockholders to purchase stock at artificially inflated prices.[55] In the district court action, the defendants' motions to dismiss for failure to state a claim and for failure to plead fraud with particularity were granted.[56] The stockholders appealed and the Court of Appeals remanded the suit finding that the stockholders did plead with particularity

49. *In re* Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1421 (9th Cir. 1994).
50. 96 F.3d 1151, 1155 (9th Cir. 1996).
51. *Id.* at 1154–55.
52. *Id.* at 1157.
53. *Id.* at 1158.
54. *Id.* at 1168.
55. 252 F.3d 63, 67 (2d Cir. 2001).
56. *Id.* at 67–68.

and did state a claim in their amended complaint.[57] In remanding the case, the court also held that through the facts alleged in the pleadings, Maruchek, the defendant corporation's officer, would have been "in a position to know Scholastic's sales/return data and evaluate whether statements disseminated to the public accurately reflected such information."[58] The case exemplifies what amount of facts is necessary in the complaint to pass the test of whether plaintiff stated a claim.

In *Dellastatious v. Williams*, the Fourth Circuit Court of Appeals discussed how control persons may escape liability by proving that they acted in good faith with regard to the securities violation.[59] "A defendant can satisfy the good-faith defense by demonstrating that he used reasonable care to prevent the securities violation."[60] In this case, "where shareholders allege[d] that directors had insufficiently supervised the corporation's affairs, the directors [could] avoid liability by showing that they attempted in good faith to ensure that an adequate corporate information gathering and reporting system was in place."[61] The court found that Donald Williams and Raymond Kelly, the principal officers, "were neither negligent nor reckless in relying on those methods and on the experience of the other directors."[62] Therefore, the court held that defendants could escape liability based on the good faith exception.[63]

Another recent case dealt with a class action suit brought by investors in a bankrupt corporation against the defendant corporation's officers, directors, accountants and financial advisors, alleging securities fraud and violation of the Securities Exchange Act provisions governing proxy statements.[64] The district court denied the defendants' motion to dismiss, and, on appeal, some of the defendants moved for summary judgment.[65] In light of the facts plaintiffs had identified, the court found that "a reasonable juror could conclude that [the] defendants did not have a genuine belief in the accuracy of the financial statements or that if [the] defendants did believe that the financial statements were accurate, then they did not act with due care in

57. *Id.* at 78.
58. *Id.* at 76.
59. 242 F.3d 191, 192–93 (4th Cir. 2001).
60. *Id.* at 195.
61. *Id.* at 196.
62. *Id.* at 197.
63. *Id.*
64. *In re* Reliance Securities Litigation, 135 F. Supp.2d 480, 486 (D. Del. 2001).
65. *Id.* at 486–87.

researching the true financial state of [the corporation]."[66] Therefore, the court found that "[the] defendants were not entitled to summary judgment that they did not act recklessly in approving publicly disclosed documents that may have had misstatements or omissions."[67]

In *Halperin v. EbankerUSA.com, Inc.*, investors brought a securities fraud class action suit against three corporations and several officers and directors, alleging that the defendants fraudulently misrepresented their future registration of certain securities with the Securities and Exchange Commission.[68] The court looked at the cautionary language in the memoranda to determine whether anything stated therein would misrepresent facts to the plaintiffs.[69] The standard the court used was that: "when cautionary language is present, the court will analyze the allegedly fraudulent materials in their entirety to determine whether a reasonable investor would have been misled."[70] "The touchstone of the inquiry is not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered."[71] Consequently, the court held that the securities offerings did not contain any material omissions and thus the plaintiffs' claims were dismissed.[72]

In Re Lernout and Hauspie Securities Litigation is a case involving a securities fraud class action brought under § 10(b) [of what?] against a Belgian corporation, Lernout & Hauspie ("L & H"), which developed and licensed speech technologies.[73] Four chief executives, who were also defendants in the suit, moved to dismiss the action.[74] Plaintiffs' allegations of fraud against the senior officers fall into three categories:

> (1) the massive overstating of L & H revenues and earnings in publicly reported statements and consolidated financial results resulting from a wide range of improper accounting practices;

66. *Id.* at 508.
67. *Id.*
68. 295 F.3d 352, 354–55 (2d Cir. 2002).
69. *Id.* at 356–57.
70. *Id.* at 357.
71. *Id.*
72. *Id.* at 361.
73. 208 F.Supp.2d. 74, 77 (D. Mass. 2002).
74. *Id.* at 78.

> (2) misleading statements regarding L & H's Korean subsidiary's revenues and earnings and the concealment of its fraudulent accounting practices; and
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> (3) misleading statements and omissions related to the use of 'strategic partner' and related company transactions.[75]

"The court adhered to the standard that [e]ach defendant may be held responsible for the false and misleading statements contained in the financial statements he signed."[76] In this case, all four senior officers were found to have signed the financial statements, which allegedly contained false financial information.[77] To hold defendants responsible for the group-published information, the plaintiffs must sufficiently allege that each individual defendant is a "clearly cognizable corporate insider with [an] active daily role in the relevant companies or transactions."[78] Through the facts of the case, the court found each of the four officers liable.[79] The Court however declined to apply the group pleading doctrine with respect to statements regarding the Korean operations.[80] Finally, the court concluded that "the company's alleged material misrepresentations in the 1998 and 1999 annual reports understating the portion of its revenues from related-party transactions also could be charged to the individual defendants under the group pleading doctrine."[81]

IV. PRIMARY, SECONDARY AND CONTROLLING PERSON THEORIES

From the beginning, the SEC has struggled with how to define who should be held liable for securities violations.[82] The

75. *Id.*
76. *Id.* at 84.
77. *Id.*
78. *Id.*
79. *In re* Lernout & Hauspie Securities Litigation, 208 F. Supp. 2d 74, 84 (D. Mass. 2002).
80. *Id.* at 85.
81. *Id.* at 85–86.
82. *See generally*, JAMES D. COX ET AL., SECURITIES REGULATIONS: CASES AND MATERIALS, 812 (3rd ed., Aspen Publishers 2001) (1943); Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999).

courts have found it helpful to distinguish the violators into so-called primary and secondary violators.[83] A primary violator is the person who commits the act, while the secondary violator either assists or supports the primary violator or is liable due to the relationship with the primary violator.[84] Courts have usually used these distinctions when reviewing liability for attorneys, accountants and underwriters.[85] The Supreme Court rejected liability based on aiding and abetting in *Central Bank of Denver v. First Interstate Bank of Denver*.[86] The Court used the term primary participant, yet this term proved useless and the courts have been grappling with what qualifies as a primary participant ever since.[87] Most decisions have focused on the degree that the defendant was a "substantial participant" in the making of the misleading statement.[88] The Ninth Circuit, applying the substantial participation test, held that primary participant liability was sufficiently pleaded by allegation that the accountants and underwriters had a significant role in drafting, reviewing, and editing the misleading financial reports, and had deliberately chosen to conceal the truth.[89] Courts have also held directors liable when they signed documents prepared by others which the directors knew materially misrepresented the firm's financial position.[90]

Section 15 of the Securities Act and Section 20(a) of the Exchange Act hold control persons liable to the same extent as the person they control.[91] Some courts' test of control depends upon one's status, for example, chairman of the board, while other courts' test inquires into certain functional considerations.[92] Clearly, in some areas control is easier to establish by one's

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83. *See, e.g.*, James D. Cox et al., *supra* note 82, at 812.

84. *Id.*

85. *See, e.g.,* DBLKM Inc. v. Resolution Trust Corp., 969 F.2d 905, 906 (10th Cir. 1992); *In re* Checkers Securities Litigation, 858 F. Supp. 1168, 1179 (M.D. Fla. 1994); Kahn v. Chase Manhattan Bank, 760 F. Supp. 369, 375 (S.D.N.Y. 1991); John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 490 (2002).

86. 511 U.S. 164, 191 (1994).

87. COX ET AL., *supra* note 82, at 821.

88. *Id.*

89. *Id.*

90. *Id.* at 822; (*see also* Howard v. Everex Systems, Inc., 228 F.3d 1057, 1062 (9th Cir. 2000) (stating that "Key corporate officers should not be allowed to make important false financial statements knowingly . . . yet . . . shield themselves from liability to investors simply by failing to be involved in the preparation of those statements;"); *see also* AUSA Life Ins. Co. v. Dwyer, 928 F. Supp. 1239 (S.D.N.Y. 1996) (signer of Form 10-K with knowledge of its falsity can be primary violator).

91. COX ET AL., *supra* note 82, at 825.

92. *Id.* at 829.

status.[93] For example, employers are controlling persons when the employee's misconduct occurs within the scope of employment.[94] Promoters are control persons as to their fellow promoters.[95] Regardless of the tests applied by the courts, the question still remains whether Congress intended to reach those whose involvement through control is on such a scale that they are "culpable participants," or whether it intended to impose liability upon those who, because of the control they hold over the primary violator, could have prevented the harm to the plaintiff, but instead were passive.[96] Courts have made the distinction of when to hold officers liable for the corporate acts. However, as all common law is victim to, the judicially enacted definitions leave much to be litigated and offer no bright line tests. Unless plaintiffs proved with a certain amount of accuracy that the officers had actual knowledge, the law gave them little power. That was all about to change.

V. CHANGES IN THE MARKET AND THE WORLD

The mid-1980s, like today, saw a build up of allegations of fraudulent business practices.[97] This "stemmed from charges that federal government defense contractors were intentionally including unallowable costs in proposals for government reimbursement of overhead expenses."[98] In response, Congress enacted laws, one of which required a senior executive of a government contractor to certify, to the best of his or her knowledge and belief, that all costs included in an indirect cost proposal were allowable.[99]

In 1998, the SEC formally proposed an executive certification for the first time in the Aircraft Carrier Release.[100] It

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93. *Id.*

94. *Id.*

95. *Id*. (citing G.A. Thompson & Co. v. Partridge, 636 F.2d 945 (5th Cir. 1981)); *see also In re* Miller Indus., Inc., 12 F. Supp 2d 1323, 1333 (N.D. Ga. 1998) (position as officer and director enabled defendant to control company's officers); *but see* Domarko v. Hemodynamics, Inc., 848 F. Supp. 1335, 1338–41 (W.D. Mich. 1993) (outside directors not control persons, but director who also served as general counsel and reviewed most corporate announcements and drafted a communication that contained many misrepresentations was a control person).

96. COX ET AL., *supra* note 82, at 831.

97. Dale H. Oliver & Joseph N. Akrotirianakis, *The Enforcement of Previous Legislation Offers Important Lessons on How the New Executive Certification Requirements will be Applied*, LOS ANGELES LAWYER, Nov. 2002, at 29.

98. *Id.*

99. *Id.*

100. Bruce Bennett & Graham Robinson, *Executive Certifications*, PRACTICING LAW INSTITUTE, Nov. 7–9, 2002 at 537 (*citing* SEC Release No. 33-7606A (Nov. 13, 1998)). This

required certification by each principal executive officer and a majority of the board of directors and covered both periodic reports and registration statements.[101] Although the goal of the SEC may have been to increase executive involvement in Exchange Act reporting, the American Bar Association was less optimistic.[102] In its comment letter to the SEC, the Committee on the Federal Regulation of Securities of the Section of Business Law of the bar wrote that "if the Commission is concerned about signatories signing blank signature pages without even reviewing a draft of the substantive document, we do not believe that this additional certification by the officers or directors who engage in conduct will likely modify their behavior."[103] Another comment letter disagreed further with the SEC's conclusion that Securities Act registration statements were of a higher quality than Exchange Act reports:

> We do not believe that adding formalistic requirements will result in a higher degree of completeness or correctness of the substantive information contained in an Exchange Act filing. Nor do we believe that a case has been made that Exchange Act filings are not in the overwhelming number of cases complete and correct.[104]

Eventually, the SEC abandoned most of the Aircraft Carrier Release's certification proposals.[105]

Former Enron CEO Jeffrey Skilling testified before a congressional committee that he was "not aware of any inappropriate financing arrangements designed to conceal liabilities or overstate earnings" following the collapse of Enron.[106] The SEC was finally convinced to try certification once again after investors were outraged with the "I didn't know"

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release was formally titled "The Regulation of Securities Offerings," but practitioners have tended to refer to it as the "Aircraft Carrier Release." *Id.* at 576.

101. *Id.*

102. *Id.* at 538.

103. *Id.* (*quoting* Comment Letter to SEC Release 33-7606A (Nov. 13, 1998) of Committee on the Federal Regulation of Securities of the Section of Business Law of the American Bar Association, Sept. 28, 1999 at IV(A)(4)(a)).

104. *Id.* (*quoting* Comment Letter to SEC Release 33-7606A (Nov. 13, 1998) of Committee on Securities Regulation of the Business Law Section of the New York State Bar Association, July 30, 1999 (revised Aug. 6, 1999) at X(3)(a)).

105. *Id.* at 539.

106. Bennett & Robinson, *supra* note 100, at 540 (*quoting* Testimony of Jeffrey Skilling before House Committee on Energy and Commerce, Feb. 7, 2002, http://energycommerce.house.gov/107/hearings/02072002Hearing485/Skilling797.htm).

defense and with the growing list of companies involved in accounting scandals.[107] On June 17, 2002, the SEC proposed CEO and CFO certification of annual and quarterly reports.[108] The SEC responded to previous opposition to mandated executive certification from the bar and public companies by saying "[w]e believe that any senior corporate official who considers his or her personal involvement in determining the disclosure to be presented in quarterly or annual reports to be an 'administrative burden,' rather than an important and paramount duty, seriously misapprehends his or her responsibility to security holders."[109] "This June 17, 2002 proposal would ultimately be displaced by the certification requirements contained in the Sarbanes-Oxley Act of 2002."[110]

On June 25, 2002, WorldCom announced that it had discovered "certain transfers from line cost expenses to capital accounts . . . [that] were not made in accordance with generally accepted accounting principles," thus requiring a nearly $4 billion restatement.[111] The next day, after this announcement, the then SEC Chairman Harvey Pitt promised mandatory retrospective certification by CEOs and CFOs at America's largest public companies, aimed at "assur[ing] investors that the financial statements they presently rely upon are in fact reliable."[112] "The SEC followed through on June 27, 2002, when it announced Order 4-460, requiring the CEO and CFO of the 947 largest companies in America to certify, separately and under oath, their companies' most recent Form 10-K and any Form 10-Q, Form 8-K and definitive proxy materials filed since the most recent Form 10-K."[113]

While the SEC was busy issuing orders requiring certification, Congress was in the process creating legislation that focused solely on corporate responsibility and accountability.

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107. *Id.* at 540–41.

108. Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34,46079, Fed. Sec. L. Rep. ¶ 1 (June 14, 2002).

109. *Id.* at ¶ 2.

110. Bennett & Robinson, *supra* note 100, at 542.

111. *Id.* (*quoting* WorldCom Announces Intention to Restate 2001 and First Quarter 2002 Financial Statements, June 25, 2002, *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/06-25-2002/0001753961&EDATE=).

112. *Id.* at 542–43 (*quoting* Remarks Before the Economic Club of New York, Chairman Harvey L. Pitt, June 26, 2002, *available at* http://www.sec.gov/news/speech/spch573.htm).

113. *Id.* at 543; *see also* Statement by the Staff of the Securities and Exchange Commission Regarding the Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 No. 4-460 (June 27, 2002), *available at* http://www.sec.gov/rules/extra/staff21a1.htm.

Michael G. Oxley proposed the legislation at that time called the CAARTA Act, Corporate and Auditing Accountability, Responsibility, and Transparency Act.[114] In a legislative hearing before the Financial Services committee, Mr. Oxley stated:

> CAARTA . . . recognizes the need for corporate leaders to act responsibly, and holds them accountable if they fail to do so. The legislation makes important improvements in the area of corporate transparency, requiring that companies disclose to investors important company news on a real-time basis. It also directs the SEC to require companies to disclose the use of off-balance sheet transaction.
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> CAARTA's provisions are designed to increase public confidence in the U.S. capital markets. It is important that they remain the world's most efficient means of promoting economic growth and providing retirement security. President Bush recently announced a ten-point plan to improve corporate responsibility and protect America's shareholders. I am pleased that the plan's core principles – providing better information to investors; making corporate officers more accountable; and developing a stronger, more independent audit system – are embodied in our legislation.[115]

During the congressional hearings regarding the proposed legislation, other testimony from an attorney in practice exemplified the need for corporate governance through the directors and shareholders:

> In the last few years in particular, and I'm sure even more so now in the post-Enron and post-Global Crossing World, independent directors have become increasingly aggressive in acting as watchdogs over their respective shareholders' interests.

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114. *Corporate and Auditing, Accountability, Responsibility, and Transparency Act (CAARTA); Hearing on H.R. 3763 Before the House Committee on Financial Services,* 107th Cong. (2002) (statement by Rep. Michael G. Oxley, Chairman, House Comm. on Financial Services).

115. *Id*. (statement of Rep. Oxley, Chairman, House Comm. on Financial Services).

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> Whether or not these policies and procedures are aggressively enforced obviously varies from company to company. On the other hand, given the proclivity of the plaintiffs' bar to act as the self-appointed protector of shareholder interests, even the most diligent beard of directors is constantly checking itself to avoid costly, unnecessary litigation. This also serves as an important catalyst for directors instituting improved corporate governance procedures and policies.
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> . . .
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> The spectra of criminal sanctions and incarceration for the most egregious misbehavior, or civil fines and sanctions for other transgressions, serves the public interest much more sensibly than allowing the elite of the plaintiffs' bar to further fatten their coffers by extracting or taxing in the form of contingency fees. . .
>
> . . .
>
> From a practical perspective, any additional government overlay from either a statutory or regulatory standpoint, may further dampen the enthusiasm of qualified people to serve as independent directors. The overwhelming majority of independent directors have been and continue to be good corporate citizens dedicated to discharging their duties to protect shareholder interests . . .
>
> . . .
>
> This legislation will help put the "fair" back in fair-value accounting.[116]

Based on the three principles: information accuracy and accessibility, management accountability, and auditor independence, President Bush announced his "Ten Point Plan to Improve Corporate Responsibility and Protect America's Shareholders" on March 7, 2002.[117] The SEC's proposed rules and

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116. *Id.* (statement of Joseph V. Del Raso, Partner, Pepper Hamilton LLP).

117. Press Release, The White House, Fact Sheet: Corporate Fraud Conference Sponsored by President's Corporate Fraud Task Force, The President's Leadership in Combating Corporate Fraud (Sept. 26, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/09/20020926-2.html.

policies conformed to the President's Ten Point plan.[118] The main areas included in the President's Ten Point Plan dealing with executive officer liability were:

> CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements.
>
> CEOs or other officers should not be allowed to profit from erroneous financial statements.
>
> CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.
>
> Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain.
>
> Investors should have complete confidence in the independence and integrity of companies' auditors.[119]

The President signed the Sarbanes-Oxley Act on July 30, 2002, "the most far-reaching reform of American business practices since the time of Franklin D. Roosevelt."[120] Due to the policies implemented by the SEC, fiscal year to date, the SEC has filed a record 156 actions for financial reporting and issuer disclosure violations, 51 percent higher than were filed in all of fiscal 2000.[121] "During this same period, the SEC has sought to throw 107 unfit officers and directors out of corporate boardrooms, almost 3 times the number that were sought in fiscal 2000."[122] The SEC has also "sought to recover compensation, bonuses and stock options paid to 25 corporate wrongdoers, that is 39% more than in the prior fiscal year."[123]

VI. CHIEF OFFICER LIABILITY AND THE SARBANES-OXLEY ACT

The main provisions of the Act include the following:

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118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. Press Release, The White House, Fact Sheet: Corporate Fraud Conference Sponsored by President's Corporate Fraud Task Force, The President's Leadership in Combating Corporate Fraud (Sept. 26, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/09/20020926-2.html.

1. Create a self-regulatory body, the "Public Company Accounting Oversight Board," to regulate the accounting profession, establish auditing standards, and impose appropriate discipline in a manner that parallels the National Association of Securities Dealers' ("NASD") oversight of, and authority over, the brokerage industry;

2. Instruct the SEC to promulgate rules of practice that require attorneys appearing before it to report "evidence" of securities law violations, fiduciary breaches or similar misconduct to a "reporting" company's chief legal counsel or CEO and, if those officers fail to act "appropriately," to the company's audit committee, its independent directors, or the board of directors as a whole;

3. Require the chief executive officer ("CEOs") and chief financial officers ("CFOs") of "reporting companies" to provide on a continuing basis a prescribed certification of their company's financial statements and impose greatly enhanced criminal sanctions for certifications that are knowingly false;

4. Amend § 16(b) of the Exchange Act to obligate corporate directors, principal stockholders and officers to disclose transactions in their company's securities within two business days;

5. Protect "whistleblowers" through new criminal penalties and a private right of action for compensatory damages.[124]

As commentator John Coffee recently noted, "the Executive Certifications Section 302 of the Act instructs the SEC to adopt

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124. John C. Coffee, Jr., *A Brief Tour of the Major Reforms in the Sarbanes-Oxley Act*, 97 A.L.I.-A.B.A. 151, 154 (2002); *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002)

rules mandating that both chief executive officers and chief financial officers of public companies certify, in connection with the filing of a company's periodic reports", that:

> a The signing officer has reviewed the report and, based on the officer's knowledge, the report does not contain any material misstatement or omission and "the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
>
> b The signing officers are responsible for establishing and maintaining internal controls and have designed such internal controls as necessary to ensure that material information relating to the issuer is made known to such officers during the reporting period;
>
> c They have evaluated the effectiveness of the issuer's internal controls within the 90 days prior to the report and they have presented in the report their conclusions about the effectiveness of their internal controls as of that date;
>
> d They have disclosed to the company's auditors and to the audit committee all significant deficiencies in the design or operation of internal controls as well as any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
>
> e They have indicated in the report whether there were significant changes in internal controls that could significantly affect such control subsequent to the date of their evaluation.[125]

125. Coffee, *supra* note 124, at 162–63 (*citing* 15 U.S.C. §7241 (2002)).

The Act has also added a new criminal statute that requires chief executive officers and chief financial officers to certify that any periodic report containing financial statements filed with the SEC, pursuant to Section 13(a) or 15(d) of the Securities Exchange Act, "fully complies with the requirements" of those Exchange Act sections and that "information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[126] However, these certifications as to "fair presentation" make no reference to generally accepted accounting principles ("GAAP").[127] Thus, if material liabilities were hidden from investors in off-balance sheet transactions and even though the financial statement did comply with GAAP, a signing officer could be liable.[128] This criminal statute provides a split sentence depending on state of mind.[129] "If an executive certifies a report 'knowing' that the certification is false, he or she may be fined not more than $1,000,000 or imprisoned not more than 10 years."[130] If an executive "willfully" certifies a report "knowing" that the certification is false, he may be fined not more than $5,000,000 or imprisoned not more than 20 years.[131]

Because Section 906 is an amendment to Title 18, the federal criminal code, the SEC has stated that it does not have jurisdiction over Section 906 because it is not securities law.[132] "However, there is evidence that Congress did not intend §1350 to create a separate certification requirement, but instead to create strong criminal penalties for false certifications under the SEC-mandated certification requirement by Section 302."[133] Regardless of the intent, the Act appears to create two distinct certification provisions. Allan Beller, Director of the SEC's

126. *Id.* at 163 (*citing* 18 U.S.C. §1350 (2002)).
127. *Id.*
128. *Id.*
129. Bennett & Robinson, *supra* note 100, at 551.
130. *Id*.
131. *Id.* "Willfully" means "with the intent to violate the law." *Id.*
132. *Id.*
133. *Id.*

> The SEC is required to complete rulemaking within 30 days after the date of enactment [of the Sarbanes-Oxley Act] with regard to CEO certification under section 302. However, section 906 suggests that certification would be required upon enactment, thus the penalties would take into effect before the certification requirement is completed through the rulemaking process. I believe it was the intent of Conferees that the penalties under section 906 should not become effective until the rulemaking process is finalized.

107th CONG. REC. S7356 (daily ed. July 25, 2002)(statement of Sen. Enzi).

Division of Corporation Finance, said at the SEC's August 27, 2002 open meeting that the SEC is working with the Department of Justice to determine if it is possible to harmonize these two provisions into a single certification requirement.[134] Therefore, over time it is possible that executives to execute a single certification under Section 302, which would satisfy Section 906 and be subject to criminal liability as well.[135]

Extraordinary potential criminal penalties are created by Section 906, whereas previously liability would mostly have been limited to civil damages or might not have existed in certain cases.[136] Rather than creating new bases for civil liability, the new certification requirements resolve existing controversy over CEO and CFO liability.[137] "The SEC takes the position that an executive signing an Exchange Act report is making a 'statement' of the representations made in the report, and that as a result the signing officer can be liable under Rule 10b-5 for material misstatements in the report that are made with scienter."[138] The courts have generally supported this proposition, despite its controversial nature.[139] Additionally, while many CEOs did not sign their company's Form 10-Q before the Sarbanes-Oxley Act, the "group pleading" doctrine nevertheless potentially imposed Rule 10b-5 liability.[140] "As a result, the certification requirements may be seen as simply resolving any controversy over whether CEOs and CFOs are subject to civil liability for a material misstatement or omission in a periodic report of which the officer is aware."[141] The major change in liability comes out of Section 906, which can impose heavy criminal penalties if facts were knowingly misstated or omitted, which may be treated as not complying with Section 13(a) or 15(d) of the Exchange Act, or unfair representation of the company's operating results and financial health.[142]

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134. Bennett & Robinson, *supra* note 100, at 552.

135. *Id.*

136. *Id.* at 570. SEC filings are subject to possible criminal liability under the False Statements Act. 18 U.S.C. §1001 et. seq. However, such prosecutions have not been common, and the maximum imprisonment is far greater under Section 906 (20 years) than under the False Statements Act (for five years). *Id*. at 551, 570.

137. *Id.*

138. *Id.* (*quoting* SEC Release No. 33-8124 (Aug. 29, 2002) at II(b)(6)).

139. *Id.* (*citing* Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000)).

140. Bennett & Robinson, *supra* note 100, at 570 (*citing* Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1254 (10th Cir. 1997); Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1440 (9th Cir. 1987); *In re* The Baan Co., 103 F. Supp. 2d 1, 17 (D.D.C. 2000); Hurley v. FDIC, 719 F. Supp. 27, 33 (D. Mass. 1989)).

141. *Id.* at 570–71.

142. *Id.* at 571.

Under Section 906 the CEO and CFO are required to certify that the certified report "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act."[143] However, a materiality qualifier is not included in this certification.[144] "Therefore, a certifying executive could face civil and criminal liability for even an immaterial mistake in complying with Exchange Act requirements for the report being filed, although it would be extremely unlikely that such an action would be brought unless it was in connection with far more serious violations of law."[145] These criminal sections of the Act create "1) a responsible relation between a company's most senior officers and the accuracy of the company's financial statements, and 2) a duty, within the scope of this prescribed responsibility, to ensure personally that the company's reports to the SEC 'fairly present' the company's financial condition."[146]

VII. EFFECTS OF THE SARBANES-OXLEY ACT

A. *Director and Officer Liability Insurance*

Directors and Officers ("D&O") liability insurance was a product that was first introduced in the 1930s, but not widely purchased by publicly held corporations until the 1970s with the increasing exposures to directors and officers, as well as the corporate issuer itself, through broadened judicial interpretation of liability under the federal securities laws.[147] Today, this kind of insurance is "almost universally held by public companies in the U.S. and is gaining increasing acceptance abroad as many nations have enacted securities laws that are more protective of

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143. *Id.*
144. *Id.*
145. *Id.*

> [A]n unintended, but likely unavoidable, consequence of the imposition of certification requirements is that the certifications required by Sections 302 and 906 may provide fertile ground for the plaintiff's bar in securities litigation. There is concern that compliant certifications, even if validly made at the time, can be used as ammunition in a class-action lawsuit should the company subsequently encounter difficulties. In addition, a plaintiff's lawyer could attempt to use an executive's failure to certify (or to certify in the precise form required) to establish claims that may not be justified by the underlying facts.

Id. at 571 n.92.

146. Oliver & Akrotirianakis, *supra* note 97, at 32.

147. Joseph P. Monteleone, *Directors and Officers Liability Insurance: The Sarbanes-Oxley Act of 2002 and Other Topical Issues*, 77 A.L.I.-A.B.A. 313, 315 (2002).

shareholder interests."[148] As one commentator stated: "[a]lthough it is not the role of the insurer to dictate principles of good corporate governance and compliance to its policyholders, insurers want to be proactive in ensuring that their policyholders avail themselves of all appropriate resources and training in the marketplace."[149] The stakes are high for both plaintiffs and defendants. Therefore, it is not surprising that only a minimal number of cases that survive motions to dismiss and motions for summary judgment are tried on the merits.[150] Smaller public companies are probably most susceptible to a securities fraud class action for a variety of reasons including:

> 1. Less experienced management. Oftentimes, [the] young companies are founded and largely managed by scientists and others with technical expertise. [Along with that], what they often lack are seasoned outside board members and financial professionals in management who can better steer them clear of potential securities fraud problems and mismanagement.
>
> 2. Focus on a single or small number of products. In these cases, securities and other litigation can become literally a "bet the company" scenario. For example, it may be tempting for a company to note less than accurate disclosures about a new drug awaiting FDA approval when that drug accounts for the majority of the company's projected earnings in the coming quarters.
>
> 3. Vagaries of the Initial Public Offerings (IPO) market. Although seemingly now at an end, . . . over the past several years, [there were] highly successful IPOs with rapidly escalating, and subsequently plummeting, stock prices. It becomes very difficult to manage investors' expectations in such a market. Oftentimes, when bad news first hits and the stock price

148. *Id.*

149. *Id*.

150. *See id*. (stating that the average mean of securities fraud class action settlement has reached the level of $15 million).

> take a precipitous drop, allegations of no or inadequate disclosure of the heretofore unknown to the market bad news becomes the basis of a securities fraud suit."[151]

The Sarbanes-Oxley Act has twofold implications for the D&O insurers.[152] First, the insurers should inquire to ascertain that the certifications have been made after proper inquiry of other people in management and on the board.[153] Otherwise, obtaining a written explanation of the process behind the ascertainment of the facts in the certifications should be considered.[154] Secondly, it can be argued that these certifications are only made to the SEC on behalf of the individual signatories and not necessarily as a representation or warranty to the D&O insurer.[155] Hence, the insurers should obtain a warranty statement to have the necessary protection.[156]

A main source of protection for directors, officers and the corporation itself for the monetary exposures in these suits is the D&O insurance policy.[157] "Historically, a D&O policy only afforded coverage for the directors and officers themselves and the corporation solely to the extent it lawfully indemnified them or advanced defense costs on their behalf."[158] However, the corporation was uninsured under the policy in its own capacity.[159] Ultimately in the mid-1990s circumstances changed and D&O insurers began to offer coverage for the corporate defendant, so-called "entity coverage," in the context of securities-related litigation.[160]

With scandals like Enron and WorldCom and an increase in shareholder lawsuits, demand for director and officer liability insurance has increased tremendously.[161] Despite the insurance not covering fraud, it can protect officers from financial damages related to misinformation and mismanagement.[162] "D&O

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151. *Id*. at 316.
152. Monteleone, *supra* note 147, at 318.
153. *Id*.
154. *Id*.
155. *Id*.
156. *Id*.
157. *Id*. at 319.
158. Monteleone, *supra* note 147, at 319.
159. *Id*.
160. *Id*. 319–20.
161. Elizabeth Souder, *Allianz Finds Hot Market In Liability Coverage For Directors and Officers*, WALL ST. J. EUROPE, Feb. 7, 2003, at M3.
162. *Id*.

insurance pays legal costs for [and judgments against] individual executives and directors, should they be sued for wrongful, but not criminal, acts."[163] Usually, this will kick in when shareholders sue directors or officers for giving false information.[164] Furthermore, the D&O insurance would be useful if an executive's personal assets were endangered.[165] "Such policies have long been standard for top U.S. executives and since the Enron and WorldCom Inc. fiascoes, even the heads of smaller companies are buying D&O coverage."[166] However, the strong demand is very different "from the days of the bull market when suing was about the farthest thing from the minds of shareholders, who were too busy gloating over their brokerage statements."[167] In the past couple of years since the market has gone down, the insurance market has escalated and premiums have risen greatly.[168]

Legislation by U.S. Congress, namely the Sarbanes-Oxley Act, attempts to beef up securities rules and protect shareholders, but has a drastic negative effect on the smaller companies in the capital market. As previously stated, smaller companies are more likely to be sued under securities laws for a number of reasons. Less experienced management, vagaries in the IPOs, and the focus on a small number of products contribute to the problems of smaller companies. The increase in the likelihood of being sued results in the companies' need for D&O insurance. However, due to the increase in premiums, obtaining insurance for these companies proves to be a great feat. If these companies cannot obtain the necessary insurance, their best option is simply to not list themselves as publicly traded companies on U.S. capital markets.

B. *Effect on Foreign Companies*

The SEC agreed to exempt foreign companies from some elements of the new corporate-governance legislation.[169] However, some foreign companies still view the Sarbanes-Oxley Act as a deterrent.[170] For example, German automaker Porsche AG

163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. Souder, *supra* note 161.
168. *See id*.
169. Craig Karmin & Kevin J. Delaney, *SEC's Exemption Gets Some Praise*, WALL ST. J., Jan 13, 2003, at C16.
170. *Id*.

announced that it was no longer considering a listing on the New York Stock Exchange.[171] More than 1,300 foreign companies are affected by the Act.[172] Despite some concessions regarding auditing procedures, the SEC did not exempt foreign companies from the provision requiring chief executive and chief financial officers to accept personal criminal liability for the validity of their companies' financial statements.[173] "Porsche criticized the idea of a CEO swearing an oath to accuracy of figures that are compiled by hundreds, or perhaps, thousands of employees when it explained its 'final decision' not to seek a New York listing."[174] The British insurer Benfield Group Ltd. also said that the Sarbanes-Oxley Act was the key reason why it chose to list in the London Stock Exchange rather than in the U.S.[175] Benfield stated that the "inevitable cost implications" and requirements of the Act were directly linked to the reasoning behind its decision.[176]

During a recent event, Mr. Oxley joined Sarah Teslik of the U.S. Council for Institutional Investors, Bill McLucas, a former chief enforcement officer with the SEC, and Dennis Nally, U.S. chairman of PricewaterhouseCoopers, to discuss the perceived short- and long-term implications of Sarbanes-Oxley.[177] Senator Oxley stated that he was concerned that if this situation is not handled carefully, there could be potential retaliation towards U.S. companies in the European Union.[178] Mr. McLucas stated that "there is a risk aversion in the marketplace that is not healthy for entrepreneurs who otherwise might be prepared to get back to business."[179] He also expressed apprehension that "liability concerns have taken center stage so prominently that business decisions and counseling decisions are taking a backseat to judgments about personal risk and personal liability."[180]

C. *Effect on the SEC*

As attorney, and also former director of the SEC's office of municipal securities, Paul Maco noted "[t]he most effective part of the bill is increased funding of the SEC, which has been denied

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171. *Id*.
172. *Id*.
173. *Id.*
174. *Id.*
175. Karmin & Delaney, *supra* note 169.
176. *Id.*
177. Jay Dismukes, *Where the Chips May Fall*, THE TRUSTED PROFESSIONAL (Jan. 2003), *available at* http://www.nysscpa.org/trustedprof/0103/1Tp11a.htm.
178. *Id*.
179. *Id.*
180. *Id.*

sufficient funds to carry out its mission for over a decade."[181] After its adoption, the Act created the Public Company Accounting Oversight Board, one of the centerpieces of the legislation.[182] "According to the Act, the board is there to establish standards for effective auditing of public companies."[183] The board is also supposed to conduct inspections and discipline wrongdoers.[184] Professor Baruch Lev noted "[t]he board should strive to make the certification open ended rather than the current boilerplate."[185] Although auditors should do their utmost to prevent fraud, they are not expected to eliminate fraud.[186] "However, the board's task is daunting."[187]

Although the board is a centerpiece of the legislation, journalist Peter Wallison believes its creation could turn out to be a classic policy blunder.[188] Members of the board voted to give themselves salaries of more than $450,000 and to pay the board's chairman over $560,000.[189] The board was given "the authority by Congress to pay itself, its staff and consultants market rates of compensation, and to collect the necessary funds for its operations by levying fees on all public companies."[190] The SEC has authority to approve the board's budget, but the SEC's incentives are to push the board into greater activity.[191] Because there is no legislative or financial limit on what these activities may entail, "all the related costs of compliance will be borne initially by the accounting industry and eventually by the public companies they audit."[192] The costs imposed on the regulated industry will serve as a barrier to entry for smaller firms.[193] "The additional accounting costs, together with the new liabilities for certifications placed on chief executive and financial officers, could cause many companies to withdraw entirely from the

181. Paul Maco, *Don't Count on Laws to Restore Trust in Markets*, WALL ST. J., Aug. 6, 2002, at D2.

182. Baruch Lev, *Accounting's Paper Maze*, WALL ST. J., Jan. 28, 2003, at B2.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *See* Peter Wallison, *A Costly Accounting Oversight*, NAT'L POST, Feb. 10, 2003, at FP 13.

189. *Id.*

190. *Id.*

191. *Id.* "The SEC . . . is bound to discover that it can offload projects to the board, thus saving its own appropriated funds and increasing the board's costs." *Id.*

192. *Id.*

193. *Id.*

public securities markets."[194] The increase in smaller and less well-capitalized companies as well as a reduction in the range of investments available to U.S. investors are a couple of examples of possible long term effects.[195] "Although one only hopes that these effects were not seen by Congress, it proves the old adage true: Act in haste, repent in leisure."[196]

VIII. THE ACT'S EFFECT ON INVESTOR CONFIDENCE

One of the Act's major goals was to boost investor confidence. By creating the Public Company Accounting Oversight Board, auditing practices are to be corrected so that investors can know whether the financial reports properly reflect economic reality.[197] CEOs and CFOs will soon likely face a significant increase in lawsuits.[198] While the legislation may reduce fraud, it is doubtful that legislation alone can ever eliminate it.[199] If it increases investor confidence, that shift cannot be definitive in the long-term.[200] As Maco stated, "[t]rust in the marketplace is based on more than perceived penalties for its breach."[201]

In a report that is a warning signal for the economy, the Conference Board, a business research group, stated that consumer confidence plunged to a nine-year low in October 2002.[202] The board's index of consumer confidence, which measures assessments of present and future expectations, fell from 93.7 in September to 79.4 in October.[203] This was the biggest one-month drop since the decline registered from September to October 1990.[204] In addition, it was the lowest reading on consumer confidence since November 1993, when the index stood at 71.9 and was rising as the economy recovered from the 1990-91 recession.[205] The declines are especially unnerving because consumer spending accounts for about two-thirds of the nation's gross domestic product.[206] The Conference Board survey revealed

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194. Wallison, *supra* note 188.
195. *Id.*
196. *Id.*
197. Lev, *supra* note 182.
198. Maco, *supra* note 181.
199. *Id.*
200. *Id.*
201. *Id.*
202. Kenneth H. Gilpin, *Consumer Confidence at a 9-Year Low, a Warning on Economy*, N.Y. TIMES, Oct. 30, 2002, at C9.
203. *Id.*
204. *Id.*
205. *Id.*
206. U.S. Dep't of State, Bureau of Int'l Info. Programs, *Economic Trends* (April

that consumer sentiment about then-current conditions had fallen for the fifth straight month.[207] What made the overall decline so significant, Ken Goldstein, an economist at the Conference Board said, was that consumer expectations about conditions six months from the time of the survey fell for the first time, from 97 in September to 80.7 in October.[208] "All of this is happening three to four weeks before the start of the holiday shopping season," he said. "Absent some sort of big change, this will likely have an impact on Christmas sales."[209]

In studies provided by Rating Research at the end of June of 2002, more than half of investors stated they were "not very" or "not at all" confident in corporate financial information.[210] One month earlier, less than one-fourth of investors expressed the same feeling.[211] Also shocking is the reported lack of confidence analysts have in the information they receive from their sources. Although a large majority, 92%, of analysts say that direct contact with a company and its financial reports or SEC filings is their primary source of information, only 23% feel "very confident" in the quality of information they receive from the corporations.[212] Investors are also not very confident in management; "[s]ixty-five percent of investors believe CEOs are 'not as concerned as they should be' about the reputation of their companies, with almost 47% attributing that to self-interests, including personal financial gain."[213]

Even after the enactment of the Sarbanes-Oxley Act, the survey in December showed that only 9% of individual investors stated that they were "very confident" in financial information provided by publicly traded companies.[214] "Despite legislative

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1996), *available at* http://usinfo.state.gov/journals/ites/0496/ijee/ej21.htm.

207. Gilpin, *supra* note 202.

208. *Id*.

209. *Id.*

210. Press Release, Rating Research LLC, Rating Research Survey Reveals Growing Mistrust by Investors in Investment Information (July 17, 2002), *available at* http://ratingresearch.com/news/071702.html.

> The RRC survey included two waves of interviews with 1,000 U.S. investors at the end of May and again in late June. One hundred analysts who follow the Retail, Pharmaceutical and Electric Power industries were interviewed in late June and early July. Additionally, RRC conducted a series of six focus groups among analysts in the same industries to provide further depth to the information collected in the survey.

Id.

211. *Id.*

212. *Id.*

213. *Id.*

214. Press Release, Rating Research LLC, Investor Confidence in Financial

initiatives by the federal government such as Sarbanes-Oxley and well-publicized images of senior executives in handcuffs being 'brought to justice', investors' confidence in the financial markets' integrity and transparency remains low," said Matthew Molé, co-founder of Rating Research.

> This reflects the devastating blow that recent scandals have dealt the reputation of Corporate America. It will require a vigorous and sustained effort on the part of governmental institutions, Wall Street firms, issuers themselves and other market players to restore investors' confidence. In this case, the passage of time alone will not cure the widespread malaise that has befallen the financial markets.[215]

This lack of confidence in financial information is presumably tied to investors' continued distrust in the ethics of senior management. According to an investor confidence tracking study, only 5% of individual investors say they are "very confident" that senior leadership of publicly traded companies engages in ethical business practices.[216] This measure has shown virtually no improvement since the tracking study began in spring of 2001.[217] Investors do not believe that corporate CEOs are sufficiently focused on the reputation of their companies.[218] Only slightly more than one-third of investors believe CEOs are appropriately focused on it.[219]

In the most recent survey released January 10, 2003, only one in twenty investors claim they are "very confident" that, in general, the senior leadership of publicly traded companies engage in ethical business practices.[220] More alarming is that 45% of investors say they are either "not very confident" or "not at all confident" in the ethical business practices of top management; however, this number is lower than the high of 56% reached in

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Information Remains Low (Dec. 5, 2002), *available at* http://ratingresearch.com/news/120502.html.

215. *Id.*

216. *Id*.

217. *Id.*

218. *Id.*

219. *Id.*

220. Press Release, Rating Research LLC, Individual Investors' Faith in Corporate America's Ethics Remains Dismally Low According to Rating Research Survey (Jan. 10, 2003), *available at* http://ratingresearch.com/news/11003.html.

August 2002.[221] "This represents scant improvement since we began measuring investor confidence nine months ago," said Matthew Molé.[222] "Despite efforts by the government and many companies to restore investor confidence and somewhat less media attention on corporate scandals, investors appear largely unmoved."[223] Three times as many investors claim that the actions taken by the government to address corporate corruption have had no impact on their confidence in investing their own money compared to those who claim the government's actions have increased their confidence.[224] According to the survey results, efforts by companies to fortify their corporate governance guidelines do not increase investor confidence because the efforts are either not well understood by investors or deemed minimally effective.[225] While one-fourth of investors claim stricter guidelines for corporate governance policies and procedures increased their confidence in investing in publicly traded companies, more than one-third claimed they "didn't know enough about corporate governance to offer an opinion" and three-in-ten believed stricter guidelines had no impact.[226]

The most recent tracking study also showed that investors are interested in independent ratings on companies' ethics.[227] More than one-half of the investors polled state that having available ratings on the ethical business practices of publicly traded companies will increase their confidence in their own investment decisions.[228] However, investors clearly state, that the organization providing the ratings must be credible, i.e. the organization must exhibit independence, objectivity and integrity..[229]

IX. CONCLUSION

The Sarbanes-Oxley Act comes at a time when corporate governance is a key in today's economic climate. In trying to curb some of the disastrous effects that occurred with such debacles as

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221. *Id.*
222. *Id*.
223. *Id.*
224. *Id.* (stating that 62% say "no impact" versus 19% who express "increased confidence").
225. *Id.*
226. Press Release, Rating Research LLC, Individual Investors' Faith in Corporate America's Ethics Remains Dismally Low According to Rating Research Survey (Jan. 10, 2003), *available at* http://ratingresearch.com/news/11003.html.
227. *Id.*
228. *Id.*
229. *Id.*

Enron and WorldCom, the Act imposes some of the strictest provisions ever seen to date. Among these, CEOs and CFOs are required to certify the financial statements of their corporations by signing an oath to their truthfulness. Previous cases have demonstrated that chief officers could escape liability when they proved they did not have direct control over the false statements in the documents or when they just "didn't know" that the statements were untrue. The Bush Administration along with Congress seem to believe that by greatly increasing civil and criminal penalties to chief officers for their misconduct, then those acts will vastly decrease. However, as representatives from the New York State Bar Association have stated, these formalistic requirements and their associated penalties most likely will not ensure greater reliability or accuracy to the financial statements published by these companies and their officers. Although these kinds of provisions seem good in the short-run, time will only tell what its effects will be in the end. The rules promulgated seem to have more punch in their writing than they will actually have in the real world. Corporate policies will definitely change. However, officers will now be more focused on the prospect of being sued, and yet to some fear is exactly what is needed. Others may argue that these certifications are taking time away from the officers' responsibility of managing the company. Smaller companies also are more likely to get squeezed out of the large securities market. Their tendencies to get sued will increase the costs of obtaining D&O insurance and thus make it more difficult to adhere to the strict guidelines set up by the Act. Expanding companies' scope of liability may not be the most ideal way to approach the problem; however it was apparent that some action needed to be taken. Through recent studies, it is also apparent that investor confidence has not increased. Even after the enactment of the Act, investors do not have the requisite amount of faith in chief officers and their statements. Although many are hopeful that confidence will rise again after a certain period of time, the real question is whether that time will ever come.

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