
Volume 42

Number 4 *Symposium: Unethical Says Who?: A
Look at How People and Institutions Help
Businesses Fulfill Their Ethical Obligations*

pp.1081-1128

Symposium: Unethical Says Who?: A Look at How People and Institutions Help Businesses Fulfill Their Ethical Obligations

"Unfit to Serve" Post-Enron

Regina F. Burch

Follow this and additional works at: <https://scholar.valpo.edu/vulr>



Part of the [Law Commons](#)

Recommended Citation

Regina F. Burch, *"Unfit to Serve" Post-Enron*, 42 Val. U. L. Rev. 1081 (2008).
Available at: <https://scholar.valpo.edu/vulr/vol42/iss4/2>

This Symposium is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



"UNFIT TO SERVE" POST-ENRON

Regina F. Burch*

I. INTRODUCTION

In what may well be "the biggest case you've never heard of[,] former senior executives and directors of now-bankrupt National Century Financial Enterprises, Inc. ("NCFE") allegedly "defrauded investors of more than \$3 billion."¹ Generally, the alleged fraud involves facts now too familiar to the public. Prior to its bankruptcy, privately owned NCFE purchased receivables from healthcare providers to help those providers "bridge the gap between when they treated patients and when they received payment from private insurance companies, Medicare or Medicaid."² According to the Securities and Exchange Commission's ("SEC") complaint, NCFE raised money from investors under the condition that the funds were to be used to purchase eligible receivables.³ Instead, certain NCFE directors and senior executives used the cash to make unsecured loans to distressed and failing healthcare providers owned wholly or partly by NCFE or its executives.⁴ Then, NCFE's management "conspired to conceal cash shortages by shuttling

* Associate Professor of Law, Capital University School of Law; A.B., Harvard College, 1986; M.S.A., Massachusetts Institute of Technology, Sloan School of Management, 1992; J.D., University of California, Hastings College of the Law, 1999. The author extends thanks to the faculty and administration at Capital University School of Law for research support. In addition, I would like to thank Stefan Padfield and participants in the Ohio Legal Scholarship Workshop and in the Midwest People of Color Legal Scholarship Conference 2006 Annual Meeting for their thoughtful comments on earlier drafts. I also extend thanks to Tiffany Auvdel, JD '07, for her research assistance.

¹ Associated Press, *Former Loan Firm Execs in \$3 Billion Fraud Case* (May 23, 2006), <http://www.msnbc.msn.com/id/12932980/> (last visited Feb. 22, 2008). The Securities and Exchange Commission civil complaint alleges that the defendants engaged "in an extraordinary scheme to defraud investors who eventually lost approximately \$2.6 billion." SEC v. Poulsen, No. 2:05CV1142, 2005 WL 4051274, at Summary ¶ 1 (S.D. Ohio Dec. 21, 2005). The complex and contentious bankruptcy case involved "the competing bankruptcies of over 500 separate medical provider entities in over 2,500 locations, secured bondholder claims of over \$3.5 billion, and a shortfall of over \$2.5 billion in assets. The confirmation hearing was equally complex and contentious." Jones Day, *Experience Details*, http://www.jonesday.com/experience/experience_detail.aspx?exID=S321 (last visited Feb. 22, 2008).

² Associated Press, *supra* note 1.

³ See *Poulsen*, 2005 WL 4051274, at Uncollateralized Advances ¶¶ 1-70.

⁴ *Id.* at Summary ¶ 2.

1082 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

money among various subsidiaries[,]" doctoring audit details, and falsifying books and records.⁵

In a much smaller accounting and financial fraud case involving only \$19 million, senior executives and directors of publicly-held Chancellor Corporation ("Chancellor"), a Massachusetts transportation company, allegedly conspired to inflate revenues on its books by knowingly and improperly consolidating revenue from a subsidiary over which the corporation had no control.⁶ Chancellor accomplished this by reporting fees paid by Chancellor for services not rendered and improperly reporting the bogus fees among Chancellor's assets.⁷

The differences between the two cases involved not only the scale of the fraud, but also the role played by the defendants in each. The NCFE defendants were management directors; that is, they held senior management employee positions within NCFE.⁸ Allegedly, they knowingly participated in the fraud by creating false documents and making false oral statements to the public or directing other employees to do so. By contrast, the Chancellor case involved both management and non-management directors.⁹ As with NCFE, Chancellor's management directors knowingly participated in the alleged fraud. However, according to the complaint, Chancellor's non-management directors were culpable because they turned a blind eye to the fraud and did nothing to prevent or stop the management directors' fraudulent conduct. In both cases, the SEC sought to bar the defendants from serving as officers and directors of any company whose securities are registered pursuant to the Securities Act of 1933 ("Securities Act") and

⁵ Associated Press, *supra* note 1. See also Poulsen, 2005 WL 4051274, at Misleading Agreed-Upon Procedures Reports ¶ 148, Defendant Poulsen's Participation in the Scheme to Defraud ¶¶ 154, 158; Jones Day, *supra* note 1.

⁶ SEC v. Chancellor Corp., No. 1:03-CV-10762, 2003 WL 23885225, at ¶¶ 1-8 (D. Mass. Apr. 24, 2003).

⁷ *Id.*

⁸ See Poulsen, 2005 WL 4051274, at ¶¶ 7-10.

⁹ Chancellor Corp., 2003 WL 23885225, at ¶¶ 12-21. This Article borrows the term "[n]on-[m]anagement [d]irector" from a recent article by Donald C. Clarke describing how courts and commentators use different terminology, such as "independent," "disinterested[,]" "non-executive," and "non-employee," to distinguish between inside and outside directors. See Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 78-79 (2007). Non-management directors do not hold executive positions within the corporation. *Id.* at 79. Non-management directors are often senior executives at other corporations, public sector employees who are influential in political circles, in some other way influential in the corporation's business, well-regarded academics, or former or current counsel to the corporation. *Id.*

the Securities Exchange Act of 1934 ("Exchange Act"), among other remedies.¹⁰

Section 305(b) of the Sarbanes-Oxley Act of 2002 ("SOA") authorized the SEC to bar:

any person who violated section 10(b) [of the Securities Exchange Act] or the rules or regulations thereunder from acting as an officer or director of any issuer [of a publicly-traded or registered security] . . . if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer.¹¹

¹⁰ See *Chancellor Corp.*, 2003 WL 23885225, at Prayer for Relief; *Poulsen*, 2005 WL 4051274, at Prayer for Relief. See generally Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2000).

¹¹ Securities Exchange Act of 1934, § 21(d)(2), 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78u(d)(2) (2000)). In addition to providing for bar orders on a showing of unfitness under the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 [hereinafter "Exchange Act"], the Sarbanes-Oxley Act of 2002 also authorized the SEC to prohibit an individual from serving as an officer and director if the person violates the Securities Act of 1933, ch. 38, § 17(a)(1), 48 Stat. 74 [hereinafter "Securities Act"], the provision prohibiting fraud in the offer or sale of securities, or its rules and regulations. Sarbanes-Oxley Act of 2002, § 1105(b), P.L. 107-204, 116 Stat. 745, 780 (2002) (codified as amended at 15 U.S.C. § 77h-1(f) (2000)). The SEC now can issue these orders in an administrative proceeding on a showing of unfitness, in contrast to the earlier standard, substantial unfitness. See 15 U.S.C. § 78u(d)(2) (2000). Courts have used Professor Jayne Barnard's suggested factors to determine whether an executive should be barred because the executive is substantially unfit to serve. See, e.g., *SEC v. Shah*, No. 92-CIV 1952, 1993 WL 288285, at *7 (S.D.N.Y. July 28, 1993) (discussing and applying Professor Barnard's factors, including: "(1) the 'egregiousness' of the underlying securities law violation; (2) the defendant's 'repeat offender' status; (3) the defendant's 'role' or position when he engaged in the fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood that misconduct will recur"); *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995); see also Jayne W. Barnard, *When is a Corporate Executive "Substantially Unfit to Serve?"*, 70 N.C. L. REV. 1489, 1510-22 (1992) (proposing a factor test used by federal courts to determine whether a bar order is an appropriate remedy); Jayne W. Barnard, *The SEC's Suspension and Bar Powers in Perspective*, 76 TUL. L. REV. 1253, 1259 (2002) (describing courts' use of her proposed factors). Although the standard under SOA has changed from "substantial unfitness" to "unfitness," courts have continued to use the tests developed under the previous standard. Stephen J. Crimmins, *Where are We Going with SEC Officer and Director Bars?*, 38 SEC. REG. & L. REP. 717, 718 (2006). However, these tests may result in liability in under more limited circumstances than Congress intended. See *infra* Section V.D; see also Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley*, 56 ADMIN. L. REV. 135, 148 (2004). But see Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391, 414-17 (2004) (describing the "[i]nherent [i]llegitimacy of a [l]ifetime [b]ar [o]rder.").

1084 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

This Article proposes that both management and non-management directors who knowingly or recklessly engage in accounting and financial fraud are unfit to serve and should be barred from serving as officers and directors of publicly traded corporations. Moreover, directors who knowingly or recklessly fail to halt or disclose accounting fraud and similar unlawful behavior should be temporarily or permanently barred from serving as officers or directors of public corporations. In particular, this article proposes that non-management directors' reckless failures to respond to red flags may amount to an intentional omission of material information and violate the Securities Exchange Act, Section 10(b), among other federal laws.¹²

It may be well accepted that willful accounting fraud violates specific provisions of the federal securities laws. Also, it may not be controversial that executives who fail to respond to red flags indicating accounting fraud may be found to have violated the federal securities laws. More controversial is that such executives—both management and non-management directors—may be found unfit to serve as officers and directors of public corporations and may be permanently barred from service.

Accounting fraud may be the most pervasive type of fraud infecting modern corporations. As demonstrated by NCFE and Chancellor, such schemes may be facilitated by management directors and senior executives who know how to hide fraud within the camouflage of legitimate transactions, by non-management directors who fail to investigate obvious red flags, by ineffective internal control systems, and by accountants, lawyers, bankers, and analysts who are *captured* by their

¹² See 15 U.S.C. § 78j(b) (2000). Under Section 10(b) of the Exchange Act, it is unlawful: To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. Likewise, Rule 10b-5 prohibits:

[the] [e]mployment of manipulative and deceptive devices. . . (a) To . . . defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2007).

clients.¹³ Executives who know of accounting fraud and take no steps to prevent the fraud may be liable for violating fiduciary duties as set forth in state corporation statutes or for violating disclosure requirements as set forth in federal securities law.¹⁴ However, executives who recklessly ignore signs of accounting fraud may not be liable under state or federal law unless it can be shown that those executives should have known of the red flags and that their failure to know demonstrates an egregious lapse of care under state law standards or violates antifraud provisions under federal securities law.

It has been very difficult under both federal securities laws and state laws to hold executives responsible for accounting fraud or for aiding and abetting such fraud, although recent successes have been achieved. Federal criminal trials for violations of federal securities laws are lengthy, involve large resource expenditures by government prosecutors, require sifting through thousands of pages of corporate documents, and involve many corporate employees and other individuals. The U.S. Department of Justice ("DOJ"), which has exclusive authority over criminal enforcement of federal securities laws, must show that the defendant acted willfully or knowingly and must establish its case by proof beyond a reasonable doubt.¹⁵ Under these circumstances, "it is invariably very difficult to assign individual fault."¹⁶

Also, private plaintiffs' ability to enforce federal securities laws in state court is constrained by federal legislation—including the Private Securities Litigation Reform Act of 1995 ("PSLRA"),¹⁷ the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"),¹⁸ and the National

¹³ Capture occurs when third party gatekeepers self-identify with issuers and management and are thus unable to render an unbiased opinion regarding the truthfulness and fairness of such issuer's financial statements.

¹⁴ See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (finding that liability may result from egregious lapses in duty to monitor). See *infra* Part IV for the proposition that non-management directors may be liable under federal law.

¹⁵ See Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937 (2003) (discussing recent Department of Justice successes in criminal enforcement actions).

¹⁶ Dale A. Oesterle, *Early Observations on the Prosecutions of the Business Scandals of 2002-03: On Sideshow Prosecutions, Spitzer's Clash with Donaldson over Turf, The Choice of Civil or Criminal Actions, and the Tough Tactic of Coerced Cooperation*, 1 OHIO ST. J. CRIM. L. 443, 446 (2004).

¹⁷ 15 U.S.C. §§ 77z-1, 77z-2, 78j-1, 78u-4, 78u-5 (2000).

¹⁸ 15 U.S.C. § 78a (2000); see Pub. L. No. 105-353, Tit. 1, § 101(a)(1), 112 Stat. 3227 (1998); Securities Act § 16(b), 15 U.S.C. § 77p(b) (2000); Exchange Act § 28(f)(1), 15 U.S.C. § 78bb(f)(1) (Supp. 2002).

1086 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

Securities Market Improvement Act of 1996 (“NSMIA”)¹⁹—each passed during the Clinton administration.²⁰ Private plaintiffs in state court also face difficulty as a result of procedural and substantive hurdles, including the business judgment rule and the derivative lawsuit demand requirement, combined with protections afforded by directors’ and officers’ liability insurance.²¹ State Attorneys General confront many of the same problems in proving the fraud as those faced by federal prosecutors. Moreover, resource constraints may affect state attorneys even more severely than federal attorneys. Also, the SEC—which has the power to adopt rules to implement the federal securities laws, to bring and to judge administrative proceedings against violators of such rules, and to initiate enforcement actions in federal court—has traditionally had limited options for prosecuting fraudulent financial reporting.²² More recently, Congress provided the SEC with additional resources and additional enforcement tools in the SOA. Most significantly, Congress gave the SEC the power to permanently bar persons from serving as officers or directors of publicly-traded corporations in administrative proceedings or to seek a court-ordered bar upon a showing of unfitness.²³

¹⁹ 15 U.S.C. §§ 77z-3, 78mm, 80b-3a. (2000).

²⁰ The PSLRA, specifically, was enacted by a substantial, bipartisan Congressional vote over President Clinton’s veto.

²¹ See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1074-76 (2006); Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1388 (2006) (describing reasons why independent director liability in private plaintiff lawsuits is rare).

²² See James D. Cox & Randall S. Thomson, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 747 (2003). Before the 1990 legislation, the SEC’s options for prosecuting such violations were extremely limited: the SEC could initiate an injunctive action in federal court. See 104 Stat. at 931 (enacted “[t]o amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws”). If the misleading item appeared in a report required to be filed with the SEC, the SEC could bring an administrative action under Section 15(c)(4) of the Exchange Act, 15 U.S.C. § 78o(c)(4). However, the 15(c)(4) administrative remedy arguably was limited to requiring the registrant to correct its filing. A somewhat more sweeping administrative sanction existed under the Securities Act in the form of a stop order or refusal order when a registration statement filed with the SEC was believed to be materially misleading. More frequently, the SEC resorted to negotiations with the offending parties that culminated in a settlement embodied in a report of the results of its investigation as authorized by Section 21(a) of the Exchange Act. See 15 U.S.C. § 78u(a) (2000) (authorizing the SEC to make investigations into possible violations and to publish its findings).

²³ Previously, the SEC could seek a bar only upon a showing of substantial unfitness and only in a federal district court proceeding. See *supra* note 11 and accompanying text.

This Article argues that the SEC should vigorously pursue fraud actions against corporate directors who fall "asleep at the switch[.]"²⁴ Moreover, the SEC should forcefully exercise its regulatory authority to find such directors unfit and permanently bar these directors from service. Enforcement actions of this type may be one means to deter the accounting and financial fraud of the type exemplified by Enron, Tyco, WorldCom, and others at the start of this century. Factors that deter accounting fraud include the fear of getting caught, the likelihood of getting caught, the belief that the behavior is criminal or illegal, and the resources available for enforcement against white collar accounting fraud. While the Securities Act, Exchange Act, and SOA (or for that matter any combination of legal regulation) alone will not prevent fraud, many agree that legal regulation—and the actors who enforce the legal rules, particularly the SEC—combined with market regulation and other factors that influence behavioral norms, are strong tools to uncover fraud and enforce fair play in the securities market.

Also, falling asleep at the switch harms corporations, shareholders, the public at large, and the economy in general.²⁵ Public confidence in the securities markets reached a low point after the revelation of accounting and financial frauds at Enron, WorldCom, Tyco, and more.²⁶ The stock market experienced steep drops, some believe due to the wave of accounting restatements and consequent loss in investor confidence. In April, 2007, the market capitalization²⁷ of corporations publicly-traded on United States stock exchanges accounted for \$19.640 trillion, while total global market capitalization was around \$50 trillion.²⁸ In other words, publicly-traded U.S. corporations made up approximately forty percent of global market capitalization.²⁹ Investment in the securities of such corporations accounted for approximately "[forty-five] percent of

²⁴ Otis Bilodeau, *SEC to Go After Directors Who Ignore Fraud; Case Against Former Outside Board Member of Firm Will Be Model*, CHI. SUN TIMES, Aug. 21, 2003.

²⁵ Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 9-10 (2002).

²⁶ *Id.* at 10.

²⁷ Market capitalization is a measure of how much money is invested in a particular firm and is based on the number of shares of a firm multiplied by the share price. For example, a firm with 100 shares total in the hands of its investors, each share worth \$10, has a market capitalization of \$1000.

²⁸ WORLD FEDERATION OF EXCHANGES, *Domestic Market Capitalization*, March 5, 2007, <http://www.world-exchanges.org/WFE/home.asp?menu=406&document=4140> (last visited Feb. 22, 2008).

²⁹ Forty percent is calculated by dividing U.S. gross domestic product by global gross domestic product.

1088 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

the value of equities traded worldwide.”³⁰ Global gross domestic product approximated \$44 trillion, and United States gross domestic product accounted for approximately nineteen percent of global gross domestic product.³¹ Clearly, the economic health of corporations (and transparency into the economic condition of corporations) is essential to smooth functioning of the United States economy, if not the world economy. “[The] U.S. sneezes and [the] world catches cold[.]”³²

Moreover, while directors are not responsible for the details of corporate operations, they should be responsible for being aware of those operations to the extent that red flags regarding accounting fraud are recognized and addressed. Management directors who hold positions of responsibility within a company may face increased risk of liability post-SOA, but are not (and should not be) solely responsible for the activities of the business.³³ Management and non-management directors share corporate monitoring responsibilities. In fact, under director independence requirements in federal regulation, non-management directors may be expected to diligently monitor management directors’ activities. SOA does not include an express remedy if directors fail in their oversight and monitoring duties and as a result fail to disclose truthful, material information in financial statements or fail to ensure that such information is disclosed. Instead, this gap may be filled by the SEC under its power to enforce specific antifraud provisions in the securities laws.

³⁰ Glen Yago et al., *Home Bias in Global Capital Markets: What is the Potential Demand for U.S. Asset-Backed Securities?*, MILKEN INST. 1 (2006); Rick Newman, *Five Reasons Foreign Money Boosts the U.S. Economy*, U.S. NEWS & WORLD REP., Jan. 11, 2008, available at <http://www.usnews.com/blogs/flowchart/2008/1/11/five-reasons-foreign-money-boosts-the-us-economy.html>.

³¹ *Global Stock Values Top \$50 Trln: Industry Data*, REUTERS (London), Mar. 21, 2007, <http://www.reuters.com/article/idUSL2144839620070321> (last visited Feb. 22, 2008).

³² Michael R. Sesit, *Around the Markets: U.S. Sneezes and World Catches Cold*, INT’L HERALD TRIB., Sept. 18, 2006, available at <http://www.iht.com/articles/2006/09/17/bloomberg/bxatm.php>. See also Sergery Minaev, *The U.S. Economy Sneezes: Dollar Takes a Nosedive*, INTELLIBRIEFS, Apr. 16, 2007, available at <http://intellibriefs.blogspot.com/2007/04/us-economy-sneezes-dollar-takes.html>; Michael Chriszt, *U.S. Sneezes, World Catches Cold*, ECONSOUTH, 2d Qtr. 2001, available at <http://www.frbatlanta.org/invoke.cfm?objectId=87B67B00-6666-11D5-93390020352A7A95&method=display>. But see Tony Lopez, *When the U.S. Sneezes, the World Doesn’t Care*, THE MANILA TIMES, Apr. 17, 2007, available at <http://www.manilatimes.net/national/2007/apr/17/yehey/opinion/20070417opi6.html> (listing a number of reasons why the world will not catch a cold, and the Philippines will not catch pneumonia, from the U.S. economy’s latest sneeze).

³³ Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 455 (2005).

This Article proceeds as follows. Part II briefly overviews the duty to monitor defined in state and federal law. Part III discusses management directors' fraud, and how and why these directors' failures to monitor and to investigate corporate operations may amount to misrepresentations and omissions of financial information in violation of Section 10(b) of the Securities and Exchange Act. Moreover, it discusses how management executives may be and have been found unfit to serve when their conduct meets certain criteria. Further, it discusses the criteria used to determine whether they should be barred from serving as officers and directors. Part IV discusses non-management directors' failure to monitor and whether failure to monitor amounts to a misrepresentation or omission in violation of Section 10(b). It considers factors a court should examine to determine whether a non-management violator should be found unfit to serve and the criteria a court should consider to determine that a bar order is the appropriate remedy.

Part V considers challenges and policy issues that may arise. First, it discusses why, although they are unlikely to succeed, opponents may bring constitutional challenges. Second, the Part discusses the standard of proof for the underlying violation, the unfitness issue, and whether a bar order is the appropriate remedy. Third, Part V considers the nature of the incentives that such SEC action would create. Fourth, the Part discusses whether the SEC is fit to serve in this role of overseer and enforcer. Finally, Part V addresses the criticisms that the SEC is unlikely to fully exercise its powers to bar directors and that the SEC should not use its administrative powers to create a *de facto* federal common law duty of care. The Article concludes in Part VI.

II. THE DUTY TO MONITOR AND INVESTIGATE

A. *Duty to Monitor and Investigate Under State Law*

The duty of care and the duty of loyalty have been described as the traditional fiduciary duties owed by directors to the corporation.³⁴ Also, it is well settled that a director's duty of care includes the duty to

³⁴ See William F. Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 628 (1985); see also William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 307, 315 (Klaus J. Hopt et al. eds., 1998).

1090 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

monitor and oversee corporate activities,³⁵ as well as the duty to remain informed about the corporation,³⁶ the duty to regularly review financial statements and devote attention to board duties,³⁷ and the duty to inquire into corporate affairs.³⁸ Aspirational standards of director conduct traditionally are defined by legally binding case law and statutes and by non-binding standards of business best practice.³⁹

Two distinct factual situations give rise to the duty to monitor.⁴⁰ The first factual scenario involves a board decision regarding a specific transaction. Directors are expected to employ a reasonable decision-making process, *i.e.*, one that was “either deliberately considered in good faith or [that] was otherwise rational[,]” and to act in the good faith pursuit of corporate, not personal, interests.⁴¹ The second factual scenario involves circumstances “in which a loss eventuates not from a decision but[] from unconsidered inaction.”⁴² For example, the Model Business Corporation Act, Section 8.30(b), Comment 2, specifies that:

The standard of care associated with the oversight function involves gaining assurances from management and advisers that systems believed appropriate have been established coupled with ongoing monitoring of the systems in place, such as those concerned with legal compliance or internal controls—followed up with a proactive response when alerted to the need for inquiry.⁴³

Further, “[t]he phrase ‘devoting attention,’ in the context of the oversight function, refers to concern with the corporation’s information and

³⁵ See *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981). But see *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) (stating that the duty to monitor stems from the duties of care and loyalty).

³⁶ *Francis*, 432 A.2d at 822; see also MODEL BUS. CORP. ACT § 8.30(a), cmt. 1 (2005).

³⁷ *Francis*, 432 A.2d at 822.

³⁸ *Id.*

³⁹ *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000). The exact behavior required of directors in carefully monitoring and overseeing corporate activities will vary depending on the circumstances.

⁴⁰ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

⁴¹ *Id.* (emphasis omitted).

⁴² *Id.* at 968.

⁴³ MODEL BUS. CORP. ACT § 8.30(b), cmt. 2 (2005).

reporting systems and not to proactive inquiry searching out system inadequacies or noncompliance."⁴⁴

Three Delaware state court cases provide greater specificity to behavior required of directors engaged in overseeing general corporate operations. Two cases, *Graham v. Allis-Chalmers Mfg. Co.*⁴⁵ and *In re Caremark International Inc. Derivative Litigation*,⁴⁶ detail a corporate director's responsibility to ensure that the appropriate systems indeed have been established and are providing timely, material information about the corporation's business performance and compliance with legal requirements.

Graham involved a claim that, as early as 1943, Allis-Chalmers Manufacturing Company directors were aware of Federal Trade Commission consent decrees and alerted to alleged antitrust violations within the company. The plaintiffs claimed that the consent decrees put the directors on notice of alleged illegal activity within the company and that the directors should have taken steps to learn about ongoing antitrust violations in the company and prevent future antitrust violations from occurring in 1956, by which time at least three directors were aware of the consent decrees against Allis-Chalmers.⁴⁷ These directors, after conducting a limited investigation in 1943 and after consulting with legal counsel, concluded that the company had never been involved in antitrust violations.⁴⁸ The Delaware Supreme Court held that even though the directors knew of the 1937 consent decrees, and thus had notice of possible illegal activity in 1937, such notice was not sufficient notice of future illegal activity in 1956.⁴⁹ More importantly, the court found that without notice of possible illegal activity, the directors had no duty to put into place "a system of watchfulness which would have brought such misconduct to [the board's] attention in ample time to have brought it to an end[]" and "no duty . . . to . . . ferret out wrongdoing which [the board had] no reason to suspect exists."⁵⁰

Recently, *Graham* was interpreted to hold that liability for a breach of the duty to monitor should be imposed only when the directors had

⁴⁴ *Id.* Twenty-nine states have adopted the MBCA in whole or in part. *Id.* at xix. A significant number of additional states' corporate codes are based on the MBCA. *Id.*

⁴⁵ 188 A.2d 125 (Del. 1963).

⁴⁶ 698 A.2d at 959 (Del. Ch. 1996).

⁴⁷ *Graham*, 188 A.2d at 129.

⁴⁸ *Id.*

⁴⁹ *Id.* at 130.

⁵⁰ *Id.*

1092 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

actual or constructive notice of potential wrongdoing within their own organizations.⁵¹ A broader reading of *Graham*—that directors need not put in place information gathering and reporting systems regarding the corporation's compliance with law—was rejected in *Caremark*.

In *Caremark*, plaintiffs claimed that the directors knew uncertainty existed about the interpretation of the Anti-Referral Payments Law ("ARPL"), a law prohibiting healthcare providers from paying "kickbacks" to induce the referral of Medicare or Medicaid patients. Further, they claimed the directors should have known that certain Caremark officers and employees were violating the ARPL, that the directors failed to stop the illegal activities, and that the directors thus breached their fiduciary duty to pay attention and "to be active monitors of corporate performance."⁵² Essentially, the plaintiffs claimed that the directors failed to have effective information gathering and reporting systems in place.⁵³ The Chancery Court interpreted *Graham* "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."⁵⁴ Also, the court opined that corporate boards should:

assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the

⁵¹ *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 809 (7th Cir. 2003); *McCall v. Scott*, 239 F.3d 808, 818 (6th Cir. 2001); *In re Baxter Int'l S'holders Litig.*, 654 A.2d 1268, 1270-71 (Del. Ch. 1995); *In re Illinois Valley Acceptance Corp.*, 531 F. Supp. 737, 741 (C.D. Ill. 1982).

⁵² *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 967 (Del. Ch. 1996).

⁵³ *See generally id.* The essence of a *Caremark* claim is that directors breached their duty of care by failing to put in place effective information and reporting systems. In contrast, the basis of a *Graham* claim is that the breach of duty arose from the failure to take appropriate action to respond to red flags signaling obvious wrongdoing in the corporation. Some courts take the view that failure to respond to known red flags rises to the level of a sustained and systematic failure to exercise oversight, and states a claim under *Caremark*. For example, in *Abbott Labs*, the plaintiffs alleged a failure by the directors to take action in light of the red flags generated by internal controls and external sources. *Abbott Labs*, 325 F.3d at 802 (7th Cir. 2003); *see also Scott*, 239 F.3d at 816 (where plaintiffs claimed that the corporation's internal audit staff informed the Board's Audit Committee about red flags); *Benjamin v. Kim*, No. 95 Civ. 9597 (LMM), 1999 WL 249706, at *8 (S.D.N.Y. Apr. 28, 1999) (in which a sole shareholder and co-CEO of the company informed director-defendant of the existence of several serious red flags); Eric Landau, Shawn Harpen & Kristel A. Massey, *Revisiting Caremark and a Director's Duty to Monitor: The Chancery Court's Wake-up Call to Directors*, 1418 PLI/CORP 37, 52 (2004).

⁵⁴ *Caremark*, 698 A.2d at 969.

board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.⁵⁵

The *Caremark* board, in good faith, had implemented internal controls; the fault lay with employees who lacked integrity.

After *Graham* and *Caremark*, a director's duty to exercise appropriate attention includes a duty to oversee the implementation of reasonable information and reporting systems and to inquire into red flags.⁵⁶ A more recent case, *Beam ex. rel. Martha Stewart Living Omnimedia, Inc.*, further defines the duty to monitor, holding that the duty does not create a requirement for corporate boards to monitor directors' personal affairs.⁵⁷

In order to state a claim for breach of oversight, the plaintiff must allege facts that show:

(1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of⁵⁸

If plaintiffs prove that directors became aware of red flags generated by the internal controls or otherwise and took no action, then liability should follow.⁵⁹ However, in the absence of adequate proof of red flags known to the board, plaintiffs must show "a sustained or systematic

⁵⁵ *Id.* at 970. The design and implementation of internal controls and information systems is within the board's business discretion.

⁵⁶ *Salsitz v. Nasser*, 208 F.R.D. 589, 592 (E.D. Mich. 2002); *In re Citigroup Inc. S'holders Litig.*, No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003).

⁵⁷ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 975-76 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

⁵⁸ *Caremark*, 698 A.2d at 971; *see also Stewart*, 833 A.2d at 976 (quoting *Caremark*, 698 A.2d at 971); *Canadian Commercial Workers Indus. Pension Plan v. Alden*, 2006 WL 456786, at *6 (Del. Ch. Feb. 22, 2006).

⁵⁹ *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 129 (Del. 1963); *see also Caremark*, 698 A.2d at 970.

1094 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

failure of the board to exercise oversight”⁶⁰ For example, evidence demonstrating:

an utter failure to attempt to assure a reasonable information and reporting system exists [sic] []will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.⁶¹

Caremark duties implicate the duty of loyalty (and good faith, either subsumed within the duty of loyalty or as a separate duty) as well as the duty of care. In *Guttman v. Huang*, the Chancery Court stated:

Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations’ compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith.⁶²

Therefore, *Caremark* claims are not precluded by the Delaware General Corporations Code, Section 102(b)(7)’s exculpatory charter provisions. Generally, Section 102(b)(7) charter provisions—and similar provisions authorized under other state statutes—may be adopted by corporations to relieve directors of personal liability for breaches of due care. The provisions do not relieve directors of liability for breaches of the duty of loyalty nor for acts not in good faith.⁶³

Cases in which directors were found to have breached their oversight and monitoring duties are few and far between.⁶⁴ First, the presence of internal monitoring and control systems may be evidence that directors have not systematically and utterly failed to monitor

⁶⁰ *Caremark*, 698 A.2d at 971.

⁶¹ *Id.*

⁶² 823 A.2d 492, 506 (Del. Ch. 2003).

⁶³ *Alden*, 2006 WL 456786, at *6 (“[I]f the Amended Complaint adequately states a *Caremark* claim, the stated claim necessarily falls outside the liability waiver provided by [the corporation’s] 102(b)(7) exculpatory charter provision.”).

⁶⁴ See *Fairfax*, *supra* note 33, at 408-14.

corporate activities. Second, the fact that directors were unaware of red flags, despite the existence of internal monitoring and control systems, simply may be evidence of the lack of integrity of certain employees who engaged in illegal activities and the deftness with which those employees hid their illegal activities. Unawareness of red flags, in and of itself, may not create a reasonable inference that directors consciously abdicated their monitoring duties or that the systems were not reasonably designed to provide timely information to the board. Third, directors, with the possible exception of the chief executive officer and the chief financial officer, have no state law duty to inquire into the day-to-day operations of the corporation and no duty to investigate whether internal controls are effective at an operational level, so long as the internal controls are in place and directors are not put on notice that the internal controls are not working.⁶⁵

While *Caremark* provides an incentive for corporations to implement internal controls and allows for the fact that there are an infinite number of flags that directors might look into, one drawback to the *Caremark* test is that it provides no incentive for directors to probe and ask questions.⁶⁶ Consequently, unreported illegal behavior remains unreported, and corporations may develop a "don't ask, don't tell[]" culture.⁶⁷

In sum, egregious lapses in oversight—either through conscious disregard of red flags or ongoing inattention to internal controls, red flags, and information generated by the controls—may lead to liability. "[D]irectors cannot ignore red flags generated by internal control systems if those red flags are numerous, serious, directly in front of the directors, and indicative of a corporate-wide problem."⁶⁸

B. Duty to Monitor and Investigate Under Federal Law

Some scholars see a recent Delaware Supreme Court case as revealing that even in this post-Enron era of heightened liability under securities laws and higher federalized standards of corporate governance under SOA, there is no change in a director's liability in state court for

⁶⁵ See Lois F. Herzeca & Angelique Mamby, *Evolving Standards for Director Reliance*, 7 No. 8 THE M&A LAWYER 18, 18 (Feb. 2004); see also Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 498 (2006).

⁶⁶ Burch, *supra* note 65, at 502.

⁶⁷ *Id.*

⁶⁸ *Id.* at 498.

1096 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

failure to implement corporate governance best practices.⁶⁹ Federal law may define standards of care to some degree; however, the fiduciary duty and standards governing board behavior mostly have been—and remain—areas reserved to state law. For example, SOA appears to model federal law based on *Caremark*, although explicit monitoring responsibilities are more limited under federal law than under state law. SOA Section 302, for instance, requires that the audit committee establish internal complaint systems, designed to “alert the audit committee to potential problems before they have serious consequences.”⁷⁰ Also, it appears that audit committees bear the responsibility for initiating and following through on investigations and that such investigations must come from the top-down instead of from the bottom-up.⁷¹

Further, the rules promulgated under SOA define the tests to determine if internal controls are operating effectively.⁷² While the design of internal controls is still within the board’s discretion, the internal controls must be able to identify “significant deficiencies” and “material weaknesses”⁷³ and the controls themselves must be tested to determine if they operate as required.⁷⁴ In addition, SOA Section 302 places the responsibility for establishing and maintaining internal controls and ensuring that the internal controls effectively provide material financial and accounting information to corporate management squarely on the principal executive and financial officers of the corporation.⁷⁵ The chief executive officer and chief financial officer must

⁶⁹ In a recent interview for the Corporate Accountability Report, Otilie L. Jarmel expressed the widespread view that Chancellor William B. Chandler’s decision in *Walt Disney* indicates directors will not be liable for breach of fiduciary duty for failing to integrate corporate best practices into decision-making. BNA CORPORATE ACCOUNTABILITY REP., vol. 3, No. 38, at 945 (Sept. 30, 2005) (“[F]iduciary duties don’t change, even when aspirational best practices do[] . . .”). I take the view that there will be increased focus on board actions as federal reforms redefine industry standards for good corporate behavior. See Burch, *supra* note 65, at 502-03 (asserting that federal reforms will redefine industry standards that influence the standard of care applied by state courts in breach of due care cases). Although securities law claims by state prosecutors recently have had a measure of success, these enforcement actions are relatively new. Spitzer may be the most notable example. See Oesterle, *supra* note 16, at 459-60.

⁷⁰ Standards Relating to Listed Company Audit Committees, Release No. 33-8220, § II(C) (Apr. 9, 2003), available at <http://www.sec.gov/rules/final/33-8220.htm>; see 15 U.S.C. § 7241 (2000).

⁷¹ Burch, *supra* note 65, at 506-07.

⁷² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745 (codified at 15 U.S.C. § 7241 (Supp. 2003)).

⁷³ *Id.* at § 302(a)(6).

⁷⁴ *Id.* at § 302(a)(4)(C).

⁷⁵ *Id.* at § 302(a)(4).

certify in periodic financial reports to the SEC that the internal controls are in place and are operating effectively.⁷⁶ However, the SEC's release accompanying the rules that implement Section 302 notes that overall responsibility for overseeing management's design and maintenance of internal controls remains with the corporation's board of directors. As a result, SOA may stimulate the questioning that may be missing in a "don't ask, don't tell" environment.

Irrespective of arguments that federal securities disclosure requirements "create incentives for specific corporate action[]" by, for example, requiring detailed disclosure of "various corporate systems or plans[]" or an explanation of why the systems or plans are not in place, an explicit federal law cause of action for failure to oversee and monitor does not exist in SOA.⁷⁷ Furthermore, SOA's legislative history does not directly address director oversight and monitoring standards. In SOA, Congress had the opportunity to go further than it had in the past in allowing the SEC to set a federal standard of care (simply by seeking liability against directors for certain actions), either by writing a standard of care into the statute and then allowing the SEC to enforce it, or by allowing the SEC to create a standard of care under its rule-making authority and then enforcing that new standard. While the lack of Congressional action may be viewed as a deliberate decision not to intrude on law traditionally relegated to the states, it may also be viewed as the result of the haste with which Congress enacted SOA. Moreover, it may be viewed as an implicit satisfaction with, and deference to, the SEC's exercise of its adjudicatory powers prior to SOA and to judicial review of the SEC's exercise of its powers. If Congress is dissatisfied with the SEC's exercise of its enforcement powers post-SOA, then Congress can amend SOA, even though, prior to SOA, Congress was less active than the SEC and the courts in this area.

III. BARS AGAINST MANAGEMENT DIRECTORS FOR FAILURE TO MONITOR AND INVESTIGATE

In order for the SEC to bar directors through an administrative proceeding or to seek a court-ordered bar for failure to monitor and oversee corporate operations, three things must happen: (1) the SEC must prove that failure to monitor and oversee corporate operations violated Exchange Act Section 10(b) and/or Securities Act Section 17(a)(2); (2) the SEC or a court must determine that the defendant is unfit

⁷⁶ *Id.* at § 302(a).

⁷⁷ Sale, *supra* note 21, at 1380.

1098 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

to serve as an officer or director of a publicly-traded company; and (3) the SEC or a court must determine whether a temporary or permanent bar is the appropriate remedy.⁷⁸

As described above, both management and non-management directors have a duty to monitor and oversee corporate operations.⁷⁹ This Part describes typical scenarios in which management directors were found to be unfit and barred from serving as officers and directors as well as how their behavior violated Sections 10(b) and 17(a)(2). Furthermore, this Part discusses the factors the SEC and courts may use to determine whether the defendants are unfit to serve and to impose a temporary or permanent bar. Part IV then addresses the circumstances under which non-management directors might be barred from serving as officers and directors.

A. Typical Underlying Offenses and Statutes Implicated

To successfully state a civil claim under Rule 10b-5, four elements must be proven by a preponderance of the evidence.⁸⁰ First, the alleged

⁷⁸ See SEC v. Shah, No. 92-CIV 1952, 1993 WL 288285, at *6-7 (S.D.N.Y. July 28, 1993) (explaining that a court may impose a bar order on a showing that defendant violated either Securities Act Section 17(a)(1) or Exchange Act Section 10(b) and that, based on the defendant's conduct, the defendant is substantially unfit to serve as an officer or director of a publicly-traded corporation); see also Jayne W. Barnard, *Rule 10b-5 and the Unfitness Question*, 47 ARIZ. L. REV. 9, 43-44 (2005) (discussing the three elements in the context of defining the operative burden of proof); 15 U.S.C. § 78j(b) (2000); 15 U.S.C. § 77q(a)(2) (2000); *supra* note 12.

⁷⁹ See *supra* notes 12-14, 33, and accompanying text; *supra* Part II and accompanying text. Some courts and commentators suggest that management directors are subject to a heightened duty to monitor because they are more familiar with corporate operations. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 888-89 (Del. 1985) (noting a heightened state law-based fiduciary duty of care applied to management directors); *Feir v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971). What constitutes "reasonable investigation" into the accuracy and completeness of data included in a registration statement:

will vary with the degree of involvement of the individual [in the statement's preparation], his expertise, and his access to the pertinent information and data . . . Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors.

Feir, 332 F. Supp. at 577-78; see also, e.g., *Goldstein v. Alodex Corp.*, 409 F. Supp. 1201, 1203 n.1 (E.D. Pa. 1976) (reasoning that a management director would have more extensive knowledge of the facts than a non-management director, and "each must undertake that investigation which a reasonable prudent man in that position would conduct").

⁸⁰ See *supra* note 12 (quoting Rule 10b-5); *infra* Part V.B.

violation must involve an "instrumentality of interstate commerce[.]"⁸¹ This element is satisfied when a corporation's security is traded over the national securities exchanges, because such trading necessarily involves the use of interstate commerce—telephone, email, or posted mail. Second, the violation must be "in connection with the purchase or sale of any security."⁸² This element is construed broadly. Third, the required disclosure must contain a false or misleading statement (an actionable misrepresentation) or must omit certain material information required to make included information not misleading (an omission).⁸³ Fourth, the element of deception may be met when a director allows a false disclosure to be issued.⁸⁴ Federal courts have held that scienter for federal securities law claims includes willfulness, intentionality, severe recklessness, and extreme departures from the standard of care.⁸⁵

Direct SEC claims under Section 10(b) and Rule 10b-5 are often accompanied by claims that the defendants violated Section 13(a) of the Exchange Act, along with Rules 13a-1 and 12b-20,⁸⁶ Sections 13(b)(2)(A), 13(b)(2)(B),⁸⁷ and 13(b)(5), Rule 13b2-1, Rule 13b2-2, and Section 17(a) of the Securities Act. These statute sections and regulations deal with annual report filings and fraud in connection with the offer or sale of a security. These sections do not require that the SEC prove scienter. Furthermore, liability for failure to maintain adequate internal accounting controls and financial recordkeeping may arise under the

⁸¹ 17 C.F.R. § 240.10b-5 (2007).

⁸² *Id.*

⁸³ See Carl W. Mills, Note, *Breach of Fiduciary Duty as Securities Fraud: SEC v. Chancellor Corp.*, 10 FORDHAM J. CORP. & FIN. L. 439, 478 (2005).

⁸⁴ See Mills, *supra* note 83, at 480.

⁸⁵ See *Ernst and Ernst v. Hochfelder*, 425 U.S. 185, 197-99 (1976); *Fairfax*, *supra* note 25, at n.263; see also Mills, *supra* note 83, at 480-81.

⁸⁶ See *supra* note 12 (quoting Section 10(b) and Rule 10b-5); 15 U.S.C. § 78m(a) (2000); 17 C.F.R. §§ 240.13a-1, 240.12b-20 (2007); see also *supra* note 11 and accompanying text (citing in part and quoting in part Sarbanes-Oxley Act, Section 305(b), which incorporates wrongs under Section 10(b)); *In re Michael Marchese*, No. 34-47732, 2003 WL 1940244, at *5 (Apr. 24, 2003) (citing several cases holding that scienter is not required to show a violation of Sections 13(a)-(b) of the Exchange Act or of Section 17(a) of the Securities Act).

⁸⁷ See 15 U.S.C. §§ 78m(b)(2)(A)-(B) (2000); *supra* note 86 (discussing the application of *Marchese*).

Section 13(b)(2)(A) of the Exchange Act requires every reporting company to make and keep books, records and accounts that accurately and fairly reflect the issuer's transactions. Section 13(b)(2)(B) requires a company to devise and maintain a system of internal controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

Marchese, 2003 WL 1940244, at *5.

1100 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

securities laws.⁸⁸ The issue of whether or not the defendant acted with the requisite scienter under Section 10(b) usually bears the closest scrutiny.

In the archetypal scenario, one or more senior officers participate in the accounting fraud by recording false numbers in accounting records, “making up” accounting methods not in conformance with generally accepted (or other legitimate) accounting principles or creating false purchase orders and bank records.⁸⁹ Also, one or more such officers issue false and misleading press releases regarding the corporation’s earnings or revenues.⁹⁰ This behavior is deliberate fraud in violation of Section 10(b) and Rule 10b-5—the defendants willfully made misrepresentations to the public regarding the corporation’s securities. Moreover, the officers in this scenario file the false information with the SEC in required quarterly and annual financial reports, violating not only Section 10(b) and Rule 10b-5, but also statutes and regulations requiring the filing of accurate and truthful information in reports required by the SEC.⁹¹ To make matters worse, chief executive officers and chief financial officers of the offending entities (or those individuals filling those positions) violate SOA Section 301’s certification provision by signing the filings and certifying that the filings are accurate and truthful.⁹²

The issue under federal law is whether “a sustained or systematic failure of the board to exercise oversight[]” demonstrates the requisite

⁸⁸ In addition, there may be a claim that the defendants aided and abetted violations of the above provisions or caused violations of the above provisions.

⁸⁹ See, e.g., SEC v. Elsie M. Leung, No. 19558, 2006 WL 305789, at *1 (C.D. Cal. Feb. 8, 2006) (where Gemstar-TV Guide International, Inc.’s chief financial officer “directed and approved” fraudulent revenue reporting and lied to auditors about how certain transactions were structured); SEC v. Umesh Malhotra et al., No. 18162, No. 1:03CV00211 (May 30, 2003) (alleging that senior officers engaged in accounting tricks to defraud investors); SEC v. Eagle Bldg. Tech., Inc. and Anthony Damato, No. 17803, 2002 WL 31386094 (D.D.C. Oct. 23, 2002) (case in which former president and chief executive officer of Eagle Building Technologies, Inc. falsified purchase orders and bank documents so as to inflate the company’s revenues).

⁹⁰ See, e.g., SEC v. Maxxon et al., No. 19132, 2005 WL 597023 (D.N.D. Mar. 14, 2005) (President of company made false and misleading statements about company’s main product); *Damato*, 2002 WL 31386094; *supra* note 81.

⁹¹ See, e.g., *Damato*, 2002 WL 31386094 (where former president and chief executive officer Damato falsified accounting data reported to the public in annual and quarterly reports filed with the SEC); see *supra* notes 81-82; *supra* note 12 (quoting the texts of Section 10(b) and Rule 10b-5). See generally notes 78-79 and accompanying text (citing an array of statutes and regulations regarding truthful submissions to the SEC).

⁹² See, e.g., SEC v. Cedric Kushner Promotions, Inc. et al., No. 19485, 2005 WL 3304009 (S.D.N.Y. Dec. 5, 2005).

level of scienter.⁹³ Federal courts have found that egregious disregard for internal controls and monitoring suffices to establish scienter.⁹⁴ Thus, an extreme departure from reasonable monitoring and oversight may suffice for liability under federal law, even if such departure does not amount to a willful departure from due care.⁹⁵

Additional claims may arise from the above-described scheme to defraud. For example, the fact that records can easily be falsified may indicate that management directors failed to put internal controls in place, failed to devise effective internal controls, or utterly disregarded internal controls that were in place.⁹⁶ These monitoring lapses violate SOA Section 404 and play into the determination that management acted with intent to defraud. A reasonable inference is that management failed to create or use internal controls in order to avoid leaving a paper trail and to make the fraud more difficult for outside auditors, the SEC, and other watchdogs to detect.⁹⁷

One scheme involves attempts to create new accounting methodologies that stretch the limits of accounting principles, followed by the senior executives' refusals to correct errors created by the

⁹³ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). *see supra* text accompanying note 60.

⁹⁴ *Caremark*, 698 A.2d at 971; *see supra* note 77 and accompanying text (explaining the scienter requirement under securities regulation suits in federal court).

⁹⁵ *See supra* note 77 and accompanying text. A trend may exist in state courts to hold directors liable for failure to respond to red flags generated by internal control systems, even when those red flags were not directly in front of the board. *See Burch, supra* note 65, at 496-97. However, directors like Marchese and Peselman were aware of red flags, but took no steps to respond to those red flags. *See generally In re Michael Marchese*, No. 34-47732, 2003 WL 1940244 (Apr. 24, 2003); *SEC v. Chancellor Corp.*, No. 1:03-CV-10762, 2003 WL 23885225 (D. Mass. Apr. 24, 2003). Their behavior likely should suffice to establish liability in state court, unless those effects are mitigated by exculpatory provisions and directors' and officers' indemnification insurance.

⁹⁶ *See, e.g., SEC v. Solucorp Indus. Ltd.*, 274 F. Supp. 2d 379, 420 (S.D.N.Y. 2003) (holding that the president and the chief financial officer of the company "either circumvented or failed to implement" internal accounting controls for the corporation); *SEC v. CIBC Mellon Trust Co.*, No. 19081, 2005 WL 372505, at *1 (D.D.C. Feb. 16, 2005) (noting the allegation that CIBC Mellon "fail[ed] to have sufficient policies, procedures[,] and internal controls in place" and thus did not detect bribery and illegal conduct by certain of its officers and directors); *SEC v. Dale Peterson et al.*, No. 17439, 2002 WL 461337, at *1 (N.D. Cal. Mar. 27, 2002) (alleging that the CEO remarked he was "sick of people thinking Generally Accepted Accounting Principles was important" and that orders to disregard GAAP came from the top).

⁹⁷ Similarly, market timing schemes, whereby trades are executed at an earlier or later time instead of on the day the order was received, may indicate internal controls that are too easily thwarted. *See, e.g., Cedric Kushner Promotions*, 2005 WL 3304009.

1102 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

seriously flawed methodology.⁹⁸ The size of the error, the length of time the error stood uncorrected, management's refusal to correct the error despite an outside auditor's advice to do so, and attempts to hide the error from accountants are factors indicating management's attempts to defraud the investing public. For example, in one company, Waste Management, Inc., the error stood uncorrected for two years and exceeded \$100 million.⁹⁹ Moreover, Waste Management executives "concealed [the error] from the Company's outside auditors."¹⁰⁰ Failure to correct the errors amounted to failure to monitor and respond to red flags and demonstrated that management acted with scienter.¹⁰¹

In several cases against management directors, these directors manipulated accounts to inflate revenues, filed false reports with the SEC, and profited by engaging in classical insider trading. However, failure to monitor might violate Section 10(b)'s antifraud provision, even in the absence of these activities. Also, liability under Sections 10(b) and 17(a)(2) may arise in the context of offering statements if directors affirmatively state in a prospectus that they have met their state law monitoring duties. If the prospectus contains such affirmative representations, then those representations set the standard by which the SEC can measure the directors' managerial performance.¹⁰² Moreover, liability may arise if the directors totally abdicated responsibility and the statements fail to disclose that the directors were deficient in meeting their state law monitoring duties.¹⁰³ Additionally, even though liability under Section 10(b) arises only if the defendant was under a duty to speak, under both federal and state law, an affirmative false statement by management creates a duty to correct the misrepresentation.

B. Unfitness to Serve Based on Failure to Monitor and Investigate

A determination that a management director is unfit to serve is an interim step after the determination that the director has violated either

⁹⁸ See, e.g., SEC v. Deal L. Buntrock, et al., No. 18913, 2004 WL 2192396, at *1 (Sept. 30, 2004) (where senior executives failed to correct errors created by Waste Management's vice president of finance's new—but fatally flawed—accounting methodology, despite being put on notice that the methodology overstated income).

⁹⁹ See *id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* Even if the defendants initially were not dishonest, at some point during the two year period in which the directors let the error stand, the executives' behavior was fraudulent—probably at or before the point they determined to conceal the error from Waste Management's outside auditors.

¹⁰² *In re Franchard Corporation*, No. 4710, 1964 WL 67454, at *9 (July 31, 1964).

¹⁰³ *Id.*

Section 10(b) or Section 17(a)(2), and prior to the determination that the director should be barred from serving as an officer or director of a public corporation. Prior to SOA, the SEC could seek a bar order only in federal district court and only on a showing of "substantial unfitness[.]" A six-factor test used to determine "substantial unfitness[]" was developed in *SEC v. Patel*:

- (1) the 'egregiousness' of the underlying securities law violation;
- (2) the defendant's 'repeat offender' status;
- (3) the defendant's 'role' or position when he engaged in the fraud;
- (4) the defendant's degree of scienter;
- (5) the defendant's economic stake in the violation; and
- (6) the likelihood that misconduct will recur.¹⁰⁴

After *Patel* and SOA's enactment, some courts have used a slightly modified version of the *Patel* test to determine unfitness, while others have adopted additional factors, including:

the nature and complexity of the scheme; . . . the use of corporate resources [company time or resources] in executing the scheme; . . . the loss to investors and others as a result of the scheme; . . . the defendant's use of stealth and concealment; [] the defendant's history of business and related misconduct; and [] the defendant's acknowledgement of wrongdoing and the credibility of his contrition.¹⁰⁵

It is clear that Congress intended to lower the standard for measuring unfitness. Since the finding is based on a balancing test, unfitness may occur if one factor is particularly egregious or if several factors are implicated. Moreover, courts generally take a holistic approach in evaluating whether the defendant's conduct demonstrates unfitness, and SEC complaints and litigation releases generally specify misconduct along the same lines.¹⁰⁶

Under the current SEC and federal court approaches, "sustained and systematic" failures to monitor and investigate red flags may lead to a

¹⁰⁴ SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995).

¹⁰⁵ SEC v. Levine, 517 F. Supp. 2d 121, 145 (D.D.C. 2007) (citing Barnard, *supra* note 78, at 46).

¹⁰⁶ See *id.* (stating that the factors cited are neither exhaustive nor mandatory).

1104 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

determination that the defendant is unfit to serve. For example, the accounting fraud in Waste Management's case was based on a complex accounting methodology where corporate personnel executed the fraud, losses exceeded \$100 million, and the defendants concealed material information from outside auditors. Also, the defendants' conduct in that case demonstrated unfitness under the pre-SOA test. The defendants' behavior was egregious over the course of two years, and senior executives knowingly executed the fraud.

To determine the likelihood of future misconduct, courts consider past misconduct, lack of contrition, and acknowledgement of wrongdoing. For example, a senior officer who denied that he had engaged in fraud, despite strong evidence to the contrary, and who insisted that the SEC brought fraud charges because it was out to get him, was found unfit to serve. As another example, first-time offenders, who became involved with public companies after a jury verdict of fraud, were found unfit to serve "notwithstanding their status as first-time offenders[;]"¹⁰⁷ their conduct demonstrated "a spectre of [future] misconduct."¹⁰⁸

C. *The Bar Remedy for Failure to Monitor and Investigate*

In determining whether the remedies should include a temporary or permanent bar, courts use factors such as the impact and severity of the fraud, the prior history of misconduct, and acknowledgement of wrongdoing to determine whether a temporary or permanent ban is an appropriate remedy. While past violations are "not essential" for imposing a lifetime ban, "it is essential, in the absence of such violations, that a district court articulate the factual basis for a finding of the likelihood of recurrence."¹⁰⁹ Moreover, courts consider whether a conditional or limited bar is sufficient, especially where there is no prior history of unfitness, but other factors may outweigh the lack of prior history of business misconduct.¹¹⁰ For example, a defendant's continued refusal to admit wrongdoing in the face of evidence otherwise, combined with violation of a preliminary injunction, weighs in favor of a decades-long or a permanent ban.¹¹¹ Further, a base of operations in another country, with a record of violations in the other country, but no violation

¹⁰⁷ *Levine*, 517 F. Supp. 2d at 146-47 (imposing a ten-year ban in light of defendants' lack of prior unfitness).

¹⁰⁸ *Id.* at 146.

¹⁰⁹ *Patel*, 61 F.3d at 142; see *Levine*, 517 F. Supp. 2d at 146-47.

¹¹⁰ *Patel*, 61 F.3d at 142.

¹¹¹ SEC v. Robinson, No. 00 Civ. 7452, 2002 WL 1552049, at *5-6 (S.D.N.Y. July 16, 2002).

of a preliminary injunction in the U.S., weighs against a permanent ban and in favor of a twenty-year ban.¹¹² Accounting fraud, combined with public misrepresentations and failure to implement internal controls, weigh in favor of a permanent ban.

IV. BARS AGAINST NON-MANAGEMENT DIRECTORS FOR FAILURE TO MONITOR AND INVESTIGATE

Despite the unique role of non-management directors as corporate securities monitors, liability rarely exists if they fail to fulfill that function.¹¹³ And yet, non-management directors do fail, as evidenced by reports about the role of the board and non-management directors in Enron, WorldCom, and Waste Management. Non-management directors have some responsibility for internal controls; if no controls are in place or there is a systematic failure, even non-management directors should be aware of the failure and take steps to correct the problem. Further, non-management directors may be just as liable under Sections 10(b) and 17(a)(2) as management directors. If non-management directors turn a blind eye to red flags, their culpability should be analyzed under the same scheme as if a management director engaged in that conduct.

To bar non-management directors, the three levels of analysis described in Part III.A would apply, but the offending conduct likely will be different from the management director conduct that violates the rule. This Part discusses the offending conduct, the unfitness factors, and the bar order.

A. *Non-Management Directors' Failure to Monitor May Amount to Securities Fraud*

While complaints against management directors generally stem from actual falsification of accounting records, false press releases, or misrepresentations in SEC filings, complaints against non-management directors more often arise from non-management directors' awareness of and failure to prevent management directors' accounting fraud. This

¹¹² SEC v. Save the World Air, Inc., 2005 WL 3077514, at *17 (S.D.N.Y. Nov. 15, 2005) (holding that although defendant continued to protest innocence, despite evidence that he must have known of misrepresentations, defendant should be subject to a limited 20-year ban, and not a lifetime ban, even though a lifetime ban would not be an abuse of discretion). Perhaps the court was thinking he should be just Australia's problem. Prior to this case, he was cited in Australia for selling unregistered securities.

¹¹³ See generally Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

1106 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

behavior may violate Sections 10(b), 13, and 404. Four recent cases illustrate securities laws claims based on non-management failure to monitor.

1. The *Chancellor* case

Compared to the massive frauds and accounting restatements at Enron, WorldCom, Global Crossing, and Tyco, among others, in which equity, revenues, and assets were restated by hundreds of millions, if not billions of dollars, pension plans evaporated overnight, and thousands of employees became jobless, the alleged fraud at Chancellor was minor.¹¹⁴ But viewed in light of SEC enforcement trends, the case may have significant impact on corporate director behavior. The case brought by the SEC against Chancellor is notable because the SEC sought to hold Rudolph Peselman, a non-management director and audit committee member, liable for securities fraud for “recklessly sign[ing] a number of financial statements that were materially misleading” and for taking “no care to ensure their accuracy.”¹¹⁵ Also, the SEC sought permanently to ban Peselman from serving as an officer or director of any publicly traded company. The allegations against Michael Marchese, a non-management director and member of the audit committee, were essentially the same, but the SEC brought an administrative proceeding against him, seeking a cease and desist order. This difference in the type of proceeding may be due to the fact that Marchese filed a letter with the SEC expressing concerns with Chancellor’s financial reporting.

In April of 2003, the SEC filed its civil complaint against Chancellor and its senior officers (a non-management director, Peselman; Metcalf Davis, Chancellor’s independent auditor; and Gregory Davis, Chancellor’s audit engagement partner). In a related matter, the SEC filed an administrative proceeding against Michael Marchese.¹¹⁶ The SEC alleged that Chancellor’s Chief Executive Officer, Brian Adley, orchestrated an accounting fraud to overstate Chancellor’s revenue by improperly consolidating revenue from MRB, Inc. (“MRB”), a newly

¹¹⁴ Compare *supra* notes 6-7, 9-10 and accompanying text, with *supra* note 26 and accompanying text. For example, the literature dealing solely with Enron as a case study in business and legal ethics is voluminous compared to the handful of articles that discuss the Chancellor case.

¹¹⁵ SEC v. Chancellor Corp., No. 03 Civ. 10762, 2003 WL 23885225, at ¶ 5 (D. Mass. 2003).

¹¹⁶ *In re Michael Marchese*, No. 34-47732, 2003 WL 1940244 (Apr. 24, 2003); see *supra* notes 78-79.

acquired subsidiary, prior to the acquisition's closing.¹¹⁷ Further, the complaint alleged that Adley improperly caused Chancellor to report fees paid to Vestex, an entity that Adley controlled, for services purportedly rendered by Vestex to Chancellor in connection with the acquisition of the subsidiary.¹¹⁸ The SEC alleged that few, if any, services were rendered in exchange for the reported fees.¹¹⁹ Moreover, the SEC alleged that Adley directed the fees to be capitalized as an asset of Chancellor, instead of properly reporting the fees as an expense.¹²⁰ As a result of this scheme, Chancellor overstated its 1998 revenue by 177%, its net income by \$850,000, and its assets by \$3.3 million.¹²¹

In early 1999, Chancellor's outside auditors, Reznick Fedder, informed the management directors that it was improper to consolidate MRB's revenues unless Chancellor had control over MRB's operations prior to the closing. Senior management reacted by delivering to Reznick Fedder documents demonstrating effective control of MRB.¹²²

However, Reznick Fedder was not convinced that Chancellor's so-called control over MRB's affairs justified consolidating MRB's and Chancellor's financial statements.¹²³ Reznick Fedder provided to senior management accounting literature that outlined the standards to be met for proper consolidation.¹²⁴ Senior management then provided to Reznick Fedder amended documents that purported to show that Chancellor exercised the requisite control over MRB's day-to-day operations and financial decision-making according to the criteria discussed in the accounting literature provided by Reznick Fedder.¹²⁵ When Reznick Fedder refused to change its position and issue an unqualified audit opinion,¹²⁶ Chancellor's senior management fired

¹¹⁷ *Chancellor*, 2003 WL 23885225, at ¶ 2. Chancellor began the process of acquiring MRB, Inc. ("MRB"), a closely held Georgia corporation, on August 10, 1998. *Id.* at ¶ 22. Under GAAP, the financial results of the two companies could be consolidated either as of the closing date, or as of the time that Chancellor gained effective control over MRB. *Id.* at ¶ 68. The closing occurred on January 29, 1999. *Id.* at ¶ 22. Chancellor consolidated MRB's revenue in Chancellor's 1998 financial results. *Id.* at ¶ 23. The Division alleged that Chancellor gained effective control over MRB as of the 1999 closing date, and not prior to the closing date. *Id.* at ¶ 24.

¹¹⁸ *Id.* at ¶ 33.

¹¹⁹ *Id.* at ¶ 8.

¹²⁰ *Id.* at ¶¶ 12-14.

¹²¹ *Id.*

¹²² *Id.* at ¶ 24.

¹²³ *Id.* at ¶ 23.

¹²⁴ *Id.* at ¶ 25.

¹²⁵ *Id.* at ¶ 26.

¹²⁶ *Id.* at ¶ 28.

1108 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

Reznick Fedder, in part due to the dispute over consolidation of MRB's financial results.¹²⁷

Chancellor then hired Metcalf Davis. Metcalf Davis issued an unqualified audit opinion despite awareness of various red flags, including the dispute over consolidating MRB's results, concerns on the part of a senior manager on the audit team over the authenticity of the amendment, the lack of documentation of services provided by Vestex, and knowledge that consolidation of MRB's financial results and capitalization of the Vestex fees would result in reporting a significantly improved financial picture for Chancellor than would otherwise be the case.¹²⁸

After receiving notification from Reznick Fedder that it had advised Chancellor that its accounting treatment of the MRB acquisition did not comply with Generally Accepted Accounting Principles ("GAAP"), the SEC began a review of Chancellor's 1998 annual report on Form 10-KSB and other financial filings.¹²⁹ The SEC's complaint followed shortly after its review of Chancellor's filings.

The SEC alleged "Peselman was aware of the disagreement over the consolidation date and approved the dismissal of Reznick Fedder, but took no steps to determine whether Chancellor's position on that issue was incorrect."¹³⁰ According to the SEC, Peselman should have asked why Metcalf Davis approved the 1998 consolidation, "even though that approval was completely contrary to Reznick Fedder's position on the issue."¹³¹ Further, the SEC complaint alleged that Peselman, among others, knew of red flags related to the MRB acquisition and fees paid for services performed by Vestex, yet signed Chancellor's annual report for fiscal year 1998 "without taking any steps to ensure that it did not contain materially misleading statements."¹³²

The complaint charged Peselman with "engag[ing] in fraudulent activities resulting in material overstatements of revenue, income, and

¹²⁷ *Id.* Chancellor Corporation informed the SEC that Reznick Fedder had approved the filings. *Id.* at ¶¶ 40-42.

¹²⁸ *Id.* at ¶ 72.

¹²⁹ *Id.* at ¶ 43.

¹³⁰ *Id.* at ¶ 29. The complaint alleges that Reznick Fedder reaffirmed its position in a memorandum sent to the audit committee, consisting of Adley and Marchese, and at a subsequent board meeting attended by Adley, Churchill (Chancellor's President), and Peselman. *Id.* at ¶ 25.

¹³¹ *Id.* at ¶ 48.

¹³² *Id.*

assets in Chancellor's public announcements and in its filings with the Commission[.] . . . in violation of Section 10(b) of the Exchange Act . . . and Rule 10b-5" ¹³³ Further, the complaint charged Peselman with aiding and abetting Chancellor's reporting of false and misleading statements in the annual report in violation of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1. ¹³⁴ Moreover, the complaint charged that Peselman "knew, or was reckless in not knowing," that Chancellor maintained false and misleading books and records, and that Peselman "knowingly and substantially assisted Chancellor to keep and maintain false and misleading books and records" for its 1998 and 1999 fiscal years and associated fiscal quarters, ¹³⁵ in violation of Section 13(b)(2)(A) ¹³⁶ of the Exchange Act. Finally, the complaint charged that Peselman aided and abetted Chancellor's failure to devise and maintain a system of internal controls necessary to permit the preparation of Chancellor's financial statements in accordance with GAAP. ¹³⁷

The SEC sought civil monetary penalties pursuant to Section 20(e) of the Exchange Act and a permanent injunction prohibiting Peselman from violating Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act. ¹³⁸ Also, the SEC sought an order permanently barring

¹³³ *Id.* at ¶ 84-85. Also, it charged that Peselman's conduct "involved fraud, deceit, or deliberate or reckless disregard [for] regulatory requirements, and resulted in substantial loss, or significant risk of substantial loss, to other persons, within the meaning of Section 21(d)(3) of the Exchange Act." *Id.* at ¶ 86. Section 21(d)(3) of the Exchange Act allows the Commission to seek civil penalties up to \$100,000 if "(aa) the violation . . . involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and (bb) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." 15 U.S.C. §§ 78u(d)(3)(B)(iii)(aa)-(bb). A question remains as to whether such reckless disregard of regulatory requirements constitutes a crime.

¹³⁴ *Chancellor*, 2003 WL 23885225, at ¶ 7. Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), requires that companies trading on national securities exchanges file annual reports. Rule 12b-20, 17 C.F.R. § 240.12b-20 (2007), requires that filings with the SEC be updated with additional information so that those filings are not misleading. Rule 13a-1 requires the filing of annual reports for publicly-traded companies. 17 C.F.R. § 240.13a-1 (2007).

¹³⁵ *Chancellor*, 2003 WL 23885225, at ¶ 108.

¹³⁶ *Id.* at ¶ 109. Section 13(b)(2)(A) of the Exchange Act requires that publicly-traded companies maintain records that "accurately and fairly reflect the transactions and dispositions of the assets of the issuer[.]" 15 U.S.C. § 78m(b)(2)(A) (2000 & Supp. 2005).

¹³⁷ *Chancellor*, 2003 WL 23885225, at ¶ 114. Again, Peselman "knew, or was reckless in not knowing, that Chancellor's conduct was improper[.]" and "knowingly and substantially assisted Chancellor's failure to devise and maintain" such internal controls, in violation of Section 13(b)(2)(B) of the Exchange Act. *Id.* at ¶ 115.

¹³⁸ *Id.* at Prayer for Relief ¶ IV, ¶ 116.

1110 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

Peselman (among others) from serving as an officer or director of any publicly-traded company.¹³⁹

Marchese and the SEC consented to the entry of a settlement order at the institution of the cease and desist proceedings.¹⁴⁰ The order stated that Marchese “failed to perform his duties as a director. He recklessly ignored signs pointing to improper accounting treatment, thereby allowing management’s fraud to continue. He acted recklessly in signing Chancellor’s Form 10-KSB for 1998, which contained materially misleading statements.”¹⁴¹ Furthermore, “Marchese approved the firing [of Reznick Fedder] although he knew that it was at least partly due to the auditors’ disagreement with Adley.”¹⁴² Moreover, in a statement that accords even more closely with the language of due care articulated in state court opinions, the SEC alleged that “Marchese’s dereliction of his duty as an outside director is more broadly reflected in his complete failure ever to review Chancellor’s accounting procedures or internal controls, or even to become aware that he was an audit committee member[]”¹⁴³ However, as mentioned previously, possibly because Marchese cooperated with the SEC, the SEC did not seek an order barring Marchese from serving as an officer or director.

2. Other post-SOA cases

In another 2003 proceeding, the SEC charged Tucker, a non-management director and member of the audit committee at Candies, Inc., with aiding and abetting violations of Sections 10(b) and 13(a). The SEC complaint alleged that Tucker knew that Candie’s senior management engaged in accounting fraud.¹⁴⁴ Further, Tucker helped Candie’s senior management obtain false documentation in support of accounting fraud. Moreover, Tucker, as a member of the audit committee, either knew or was reckless in not knowing, that the outside auditors questioned a number of transactions and refused to sign off on

¹³⁹ *Id.* at ¶ VI.

¹⁴⁰ *In re Michael Marchese*, No. 34-47732, 2003 WL 1940244, at *1, *6 (Apr. 24, 2003); *see supra* notes 78-79. An overwhelming number of administrative proceedings are resolved through a consent decree, in which the defendant neither admits nor denies the SEC’s findings of fact or conclusions of law. As is typical in these proceedings, Marchese neither admitted nor denied the SEC’s factual findings, except as to the SEC’s jurisdiction over him and the subject matter of the proceedings. *Id.* at *1 ¶ II.

¹⁴¹ *Id.* at *1-2.

¹⁴² *Id.*; *see supra* note 118 and accompanying text.

¹⁴³ *Marchese*, 2003 WL 1940244 at *1-2.

¹⁴⁴ *SEC v. Lawrence O’Shaughnessy*, Civ. Action, 03-3021, ¶¶ 97-98 (S.D.N.Y. 2003), available at <http://www.sec.gov/litigation/complaints/comp18120a.htm>.

the financial statements. Tucker agreed to a five-year ban as part of his settlement with the SEC.

In a 2004 proceeding, the SEC charged Del Global, its senior officers, and the Chair of Del Global's Audit Committee with a three-year financial fraud involving improper accounting for an acquisition by Del Global, among other matters.¹⁴⁵ The complaint alleged that the audit committee chair, at the request of the chief financial officer and in order to satisfy concerns raised by outside auditors who questioned the transaction, falsely confirmed that his audit firm had performed accounting work related to the acquisition. The audit committee chair's conduct violated books and records provisions, internal controls provisions, and lying-to-auditors provisions.

In another 2004 proceeding, the SEC instituted cease and desist proceedings against Ture Roland Fahlin, a non-management director and member of the supervisory board of a Swiss company trading on the New York Stock Exchange, for improper accounting for a joint venture.¹⁴⁶ Fahlin signed a letter stating that Ahold had control over the joint venture for purposes of consolidating its financial results with those of the joint venture and then rescinded the letter but failed to inform the outside auditors that the letter was rescinded. The SEC charged that, "[a]s a result of Fahlin's failure to fulfill his duties described above as a member of Ahold's supervisory board and audit committee, Fahlin was a cause of Ahold's violation of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act."¹⁴⁷ However, the SEC did not seek penalties other than a cease and desist order, at the request of the Dutch Public Prosecutor's Office, which was conducting a parallel criminal investigation and sought to avoid potential double-jeopardy issues.

3. Pre-SOA cases

Prior to the early 1970's and the failure of Penn Central Company, the SEC's involvement in issues of director oversight was fairly passive.¹⁴⁸ While the SEC did fault non-management directors for failure to monitor, until recently and after SOA, it had not sought bar orders against non-management directors. However, over the intervening

¹⁴⁵ SEC v. Del Global Tech. Corp., Civ. Action, 04-4092 (S.D.N.Y. 2004), *available at* <http://www.sec.gov/litigation/complaints/comp18732.pdf>.

¹⁴⁶ *In re Ture Roland Fahlin*, <http://www.sec.gov/litigation/admin/34-50519.htm> (last visited Feb. 22, 2008).

¹⁴⁷ *Id.* at § 3.

¹⁴⁸ H. LOWELL BROWN, *BRIBERY IN INTERNATIONAL COMMERCE* § 8.7 (2003).

1112 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

years, the SEC has addressed the obligations of non-management directors where the company's violations involved possible securities fraud and where a company's violations do not constitute fraud.¹⁴⁹

In 1975, certain senior officers and employees of Stirling Homex engaged in a fraudulent scheme "to show continually increasing sales and earnings[]" by recording "fictitious sales, earnings, and assets."¹⁵⁰ Stirling Homex filed with the SEC and distributed to its shareholders "materially false and misleading registration statements, press releases, annual and periodic reports[,] and other materials . . ."¹⁵¹ The directors, who were financially sophisticated, questioned the senior officers about certain financial information that indicated an ongoing liquidity problem at the corporation.¹⁵² The directors accepted superficial answers and failed to follow-up on requests for financial information that (as it turned out) was never provided.¹⁵³ The SEC faulted the directors because:

Neither . . . [of the directors] were informed nor realized that the company was suffering serious operating and financial difficulties[,] and they made no greater effort to involve themselves in the company's affairs in 1971 or early 1972. Instead, on this and other occasions, they relied on the self-serving representations of Stirling Homex management and actions by the company's accountants, bankers, and investment counsel which they perceived to be favorable.¹⁵⁴

The SEC labeled the directors' job performance "not adequate[]" because their presence on the board did not "have the impact upon the company's operations which shareholders and others might reasonably have expected."¹⁵⁵

More recently, in 1994, the SEC charged Cooper Corporation, its former chief executive officer, and former chief operating officer with

¹⁴⁹ E.g., *In re* W. R. Grace & Co., No. 39157, 1997 WL 597984, at *1, n.4 (Sept. 30, 1997) (reporting investigation into the conduct of certain officers and directors, particularly non-management directors).

¹⁵⁰ *In re* Stirling Homex Corp., No. 11516, 1975 WL 163038, at *1 (July 2, 1975) (report of investigation relating to activities of the board of directors).

¹⁵¹ *Id.*

¹⁵² See generally *id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at *4.

¹⁵⁵ *Id.* at *5, *6.

fraudulent schemes involving frontrunning¹⁵⁶ and market manipulation of bonds, seeking an injunction against the corporation and its former chiefs.¹⁵⁷ The board of directors took no action to remove the senior officers from their management positions from which they could effectuate the fraudulent schemes, even after the board was informed that the officers were indicted and were not cooperating with independent legal counsel hired by the board.¹⁵⁸ Furthermore, the board took no steps to reclaim from the officers certain profits that the officers had obtained due to conflict of interest transactions that were unknown to the board at the time of the transaction, but that should have been disclosed to the board under the corporation's policies.¹⁵⁹ Moreover, the board allowed the senior officers to continue to operate the corporation and to issue a misleading press release that the company was reviewing the SEC's allegations and was unaware of any wrongdoing by the senior officers. This was despite the fact that the board was aware that the officers were under investigation and that the officers refused to cooperate with the board's own legal counsel. As a result of the misleading press release, the corporation was charged with violating Sections 10(b) and 13(a) of the Exchange Act.

The SEC faulted the board for not moving "aggressively to fulfill their responsibilities to oversee the conduct and performance of management and to ensure that the company's public statements [were] candid and complete."¹⁶⁰ According to the SEC, "potential violations of the federal securities laws involving self-dealing and fraud by management [were] called to the attention of the board of directors" and the board "failed to take immediate and decisive corrective action on these matters and . . . appeared to prefer management's interest in keeping the facts secret over the investors' interest in full, fair and accurate disclosure under the federal securities laws."¹⁶¹

In *Franchard*, the SEC Division of Corporate Finance (the "Division") brought stop order proceedings to suspend the effectiveness of

¹⁵⁶ An illegal front-run occurs when traders are alerted to large impending buy or sell orders and then profit by using this inside information to enter the market ahead of the large order.

¹⁵⁷ These activities also resulted in the senior officers' criminal indictments and convictions under the mail and wire fraud statutes, RICO, the Investment Advisors Act, and others.

¹⁵⁸ *In re Stirling Homex Corp.*, No. 11516, 1975 WL 163038, at *1 (July 2, 1975).

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

1114 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

registration statements pertaining to Franchard Corporation (formerly Glickman Corporation).¹⁶² The Division argued that the registration statement inadequately disclosed pledges of control stock and the transfer of corporate assets by Louis Glickman, the controlling shareholder, to a business separately owned by him, called Venada.¹⁶³ Further, the registration statement insufficiently disclosed whether the board had adequately performed its oversight functions.¹⁶⁴ The directors were informed of the secret asset withdrawals and hired outside counsel to investigate Glickman's liability for the withdrawals.¹⁶⁵ Although Glickman promised to pay back the money with interest and to cease making withdrawals, he repaid the loans with interest but continued to make improper withdrawals from Glickman Corporation.¹⁶⁶

The SEC agreed with the Division that the prospectuses were deficient because they failed to disclose Glickman's transfers of funds to Venada and his pledges of his control stock in Glickman Corporation.¹⁶⁷ Outside counsel found that Glickman Corporation's inadequate administrative procedures had to some extent facilitated the CEO's secret activities.¹⁶⁸ Nonetheless, the SEC expressed reluctance to hold the directors liable for failure to do reasonable due diligence to ensure that the financial statements were correct, for failure to establish effective procedures for monitoring and overseeing the corporation, and for failure to disclose the above secretive acts.¹⁶⁹

¹⁶² *In re Franchard Corporation*, No. 4710, 1964 WL 67454, at *9 (July 31, 1964).

¹⁶³ *Id.* at *1.

¹⁶⁴ *Id.* at *8.

¹⁶⁵ *Id.* at *3.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* The SEC addressed why disclosure of Glickman's transactions was required in the registration statement. Although some of the facts went to Glickman's personal real estate ventures, the SEC asserted that these facts were material facts and should have been disclosed for the following reasons. *Id.* at *6. First, the withdrawals were significant withdrawals of cash when measured against Glickman Corporation stockholders' equity and cash flow. *Id.* at *7. Second, the withdrawals implicated Glickman's "managerial ability and personal integrity." *Id.* at *6. Third, the offering of stock in Glickman Corporation was made primarily based on "[Louis] Glickman's name and reputation as a successful real estate investor and operator[;]" thus, investors were being offered an opportunity to buy Glickman's unique managerial expertise. *Id.* The secret transfer of funds just after the filing of the registration statement, from Glickman Corporation to Venada and Louis Glickman's pledges of his interest in Glickman Corporation stock indicated, Glickman's "strained financial position and his urgent need for cash in his personal real estate ventures[;]" facts that would be material to an evaluation of Glickman's ability to manage Glickman Corporation. *Id.*

¹⁶⁸ *In re Franchard Corporation*, No. 4710, 1964 WL 67454, at *8 (July 31, 1964).

¹⁶⁹ *Id.*

The Division argued that the directors made an implied statement that they properly managed the affairs of the corporation because the directors' names were listed in the prospectus.¹⁷⁰ Also, the Division argued that the directors did not meet the implied standard of behavior because the board did not exercise judgment independent from Glickman's influence.¹⁷¹ However, the SEC disagreed with the Division because the prospectuses "contained no affirmative representations concerning the participation of the directors in [Glickman Corporation's] affairs."¹⁷² The Glickman Corporation prospectuses did not speak to the level of the directors' management responsibility, merely because the directors' names were listed as directors. Likewise, the board met regularly and was informed by Glickman about the registration statements.¹⁷³ The directors had not made an affirmative statement regarding their duties, nor had they totally abdicated their responsibilities, according to outside counsel.¹⁷⁴

In other early cases involving non-disclosure of material information, but not accounting fraud, the SEC described a non-management director's obligation to ensure that information disseminated by corporate managers paints an accurate picture of the financial health of the company.¹⁷⁵ For example, Gould, Inc., failed to disclose, in its filings with the SEC, certain conflict-of-interest transactions between Gould and some of the members of Gould's management. The board of directors later learned of the interested transactions and approved them. In its report of the investigation, the SEC faulted the board for approving the transactions without further

¹⁷⁰ *Id.*

¹⁷¹ *Id.* The Division argued that the board was in fact a "nullity" – the directors "agreed to Glickman's proposals, derived their information as to the current state of [Glickman Corporation's] finances from Glickman's sporadic oral reports, and permitted him to fix each officer's area of responsibility." *Id.*

¹⁷² If the SEC were referring to broad statements that directors' had met their duty, then after *Franchard*, corporations would be on notice to avoid broad statements regarding managerial performance in filings with the SEC. Rather, a better view is that the SEC *was* referring to narrow statements regarding specific transactions in which board approval is required, such as fundamental corporate changes involving board interested transactions. In these situations, the SEC filing often refers to the procedure by which the board made its decision related to the transaction.

¹⁷³ Further, investors were aware that Glickman controlled the corporation and thus were on notice that he might hold sway over the board of directors.

¹⁷⁴ *Id.*

¹⁷⁵ *E.g., In re National Telephone Co., Inc.*, No. 34-14380, 1978 WL 171339 (Jan. 16, 1978); *In re Gould Inc.*, No. 34-13612, 1977 WL 175761 (June 9, 1977).

1116 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

inquiry from anyone other than those with a material interest in the approval.¹⁷⁶

In another instance, the SEC investigated a misleading filing by National Telephone Co.¹⁷⁷ The SEC alleged that the board of directors was aware that the corporation was in serious financial trouble, that management resisted making “full and fair disclosure[,]” and that “events central to the survival of the company” were involved.¹⁷⁸ Under these circumstances, the SEC cautioned that, while non-management directors need not ensure every line of a press release is accurate, non-management directors do have an obligation to ensure that press releases and reports to shareholders truthfully and fairly represent the financial health of a corporation.

More recently, in 1997, the SEC investigated W.R. Grace & Co. along with certain officers and directors for violation of the proxy disclosure rules.¹⁷⁹ Two non-management directors were aware of the information that was required to be disclosed; both reviewed the relevant documents.¹⁸⁰ The SEC concluded “that [the directors] did not fulfill their obligations under the federal securities laws[]” because “each assumed, without taking the steps necessary to confirm their assumptions, that [W.R. Grace’s] procedures would produce drafts of disclosure documents describing all matters that required disclosure.”¹⁸¹ Further, “[e]ach also assumed, without taking steps necessary to confirm their assumptions, that other corporate officers, including counsel, had conducted full and informed reviews of the drafts.”¹⁸² According to the SEC, “each had a responsibility to go beyond the established procedures to inquire into the reasons for non-disclosure of information of which they were aware.”¹⁸³

The above cases illustrate that the SEC has advised corporate directors of their responsibilities and roles in the context of overseeing the operation of corporations and the production of accurate communications to the SEC and the investing public about the financial health of corporations. However, the SEC has been unwilling to use the

¹⁷⁶ See generally Gould, 1977 WL 175761.

¹⁷⁷ *In Re National Telephone Company*, 1978 WL 171339.

¹⁷⁸ *Id.* at *4.

¹⁷⁹ See generally *In re W. R. Grace & Co.*, No. 39157, 1997 WL 597984 (Sept. 30, 1997).

¹⁸⁰ *Id.* at *2.

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.*

full array of tools at its disposal to sanction non-management directors. Indeed, the *Chancellor*, *Candie's*, *Del Global*, and *Fahlin* cases demonstrate the limits of the SEC's recent use of its formidable array of sanctions to counter the most egregious lapses in directorial oversight.

B. When are Non-Management Directors Unfit to Serve?

The factors used to determine whether a non-management director is unfit should be the same as those used to determine whether a management director is unfit. For example, Peselman, Tucker, Marchese, and Fahlin, as members of their corporations' audit committees, played key roles in facilitating fraud at their companies. If they did not have actual knowledge of fraud, they should have known of the fraud, because they reviewed financial statements and supervised the outside auditors who made the committee aware of red flags. The frauds were continuing, and senior management acted deliberately to overstate earnings. Also, accounting fraud is often complex and sophisticated. The frauds in these cases were complex, in some cases involving accounting for revenues from acquired subsidiaries and joint ventures and in other cases involving accounting for revenue from numerous sales accounts. Moreover, the defendants concealed the frauds from outside auditors. Given these facts, the non-management directors met the test for unfitness.¹⁸⁴ Notably, even the non-management directors' lack of knowledge of the internal affairs of the corporation does not excuse these directors' failures to monitor, in part because the failure to monitor is egregious. The frauds were long-standing, and violations were clearly in front of the directors.

C. Bar Orders Are an Appropriate Remedy

Not surprisingly, courts weigh similar conduct and factors once it is determined that the defendant is unfit. The test again is a balancing test. Also, the issue may be whether there is a likelihood of future misconduct. As with cases involving management directors, likelihood should be measured by evidence of a history of past misconduct, acknowledgement of wrongdoing, and evidence of contrition. Non-management directors who inform the SEC of wrongdoing or who cooperate with the SEC may face a temporary bar or a cease and desist

¹⁸⁴ See Michael Dailey, *Officer and Director Bars: Who is Substantially Unfit to Serve After Sarbanes-Oxley*, 40 HOUS. L. REV. 837, 852-59 (2003) (arguing for a factor analysis to determine whether a bar order is appropriate); see also Philip F.S. Berg, *Unfit to Serve: Permanently Barring People From Serving as Officers and Directors of Publicly-Traded Companies After the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1902-04 (2003).

1118 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

order. Directors who allow fraud to continue, or who aid and abet fraud, should face a longer bar. Further, past violations or the violation of a preliminary injunction may also weigh in favor of a bar.

V. CHALLENGES AND POLICY ISSUES

Chancellor was touted as the first salvo in a war against accounting fraud.¹⁸⁵ However, for the war to be won, the SEC must succeed in the face of several possible challenges. One set of challenges likely will stem from the argument that Congress did not delegate to the SEC the power to bring what some describe as state law fiduciary duty claims in administrative proceedings or in federal court. As the SEC itself has acknowledged, SEC review of directors' behavior implicates separation of powers issues.¹⁸⁶ Therefore, a question becomes whether Congress intended the SEC regulation of fraud to reach board oversight behavior. Neither the legislative history of the Securities Act of 1933¹⁸⁷ nor that of the Securities Exchange Act of 1934¹⁸⁸ gives an express indication that Congress intended to provide the SEC with the power to set standards of behavior or corporate directors in the performance of their oversight of corporate operations.

Moreover, the U.S. Supreme Court established in *Santa Fe v. Green* that a federal cause of action for breach of fiduciary duty does not exist.¹⁸⁹ In *Santa Fe*, the plaintiffs, holders of the seller's stock, argued that the merger price negotiated by the directors of the seller was unfair, and the directors had breached their fiduciary duty by negotiating an unfair price. The plaintiffs claimed that the inadequate price was an attempt to defraud them of their shares and was actionable under Section 10(b). *Santa Fe* can easily be distinguished from *Chancellor*, *Del Global*, *Candie's*, *Fahlin*, and the other failure to monitor cases that sound in accounting fraud, misrepresentations, and Section 10(b) violations. Despite the sound nature of these arguments distinguishing *Santa Fe v. Green*, no precedent other than *Santa Fe* exists to guide a court.

The cause of action under federal law against the directors who fail to monitor and oversee can be characterized as follows: the directors

¹⁸⁵ CHI. SUN TIMES, August 21, 2003, available at <http://www.suntimes.com/output/business/cst-fin-sec21.html>. See generally SEC v. Chancellor Corp., No. 03 Civ. 10762, 2003 WL 23885225, at Prayer for Relief (D. Mass. 2003).

¹⁸⁶ *In re Franchard Corporation*, No. 4710, 1964 WL 67454, at *8 (July 31, 1964).

¹⁸⁷ See *supra* note 10 and accompanying text.

¹⁸⁸ See *supra* note 10 and accompanying text.

¹⁸⁹ See *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

knowingly or at least recklessly failed to exercise management and oversight. If they had exercised the appropriate oversight, then they would have known or should have known of the accounting fraud. If they knew or should have known of the accounting fraud, then they had a federal law duty under the Exchange Act to ensure that the correct information was disclosed in filings with the SEC. Because they did not ensure that the correct information was disclosed in SEC filings and press releases, they breached their obligations under the Exchange Act and the regulations promulgated thereunder.

This Part will first examine whether the SEC has the power under the Exchange Act to bring what some (mis)characterize essentially as a breach of due care cause of action against non-management directors. Although some argue that "[t]he Chancellor action and the public comments of Messrs. Donaldson and Cutler together reflect the SEC's intent to target [non-management] directors for negligent activity (or inactivity) and breaches of fiduciary duty," this author argues that the SEC brings action against only those who intentionally or recklessly ignore clear warning signs, in other words, directors who knew or should have known of fraud and took no steps to stop it.¹⁹⁰ Second, this Part discusses the standard of proof for the underlying violation, the unfitness issue and whether a bar order is the appropriate remedy. Third, this Part considers the nature of the incentives that such SEC action would create. Fourth, the Part discusses whether the SEC is fit to serve in this role.

A. Constitutional Challenges

Although Congress established the SEC to regulate disclosure of corporate information and to enforce antifraud provisions, states still retain primary responsibility for regulation of corporate governance.¹⁹¹ Therefore, the issue of whether the SEC has power to regulate the internal affairs of corporations is first governed by whether Congress has the power to delegate such power to the SEC under the Commerce

¹⁹⁰ John F.X. Peloso & Ben A. Indek, *Outside Directors and Red Flags*, 231 N.Y. L.J. 3 (2004). At the time of the *Chancellor* case, Donaldson was the SEC's Chairman and Cutler its Enforcement Director. *Id.*

¹⁹¹ See Mills, *supra* note 83, at 446. The author noted: "Congress was careful to also point out[] . . . that the legislation was not intended to supplant state regulation of internal corporate governance." *Id.*

1120 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

Clause and second by whether Congress has delegated such power to the SEC under the Exchange Act (the enabling statute).¹⁹²

The courts have played a significant role in interpreting the Exchange Act, primarily through Rule 10b-5 jurisprudence.¹⁹³ The Supreme Court has explicitly recognized that Congress has power under the Commerce Clause to regulate the purchase and sale of securities, so long as such purchase and sale affects interstate commerce. A more subtle issue may be whether “the connection between a required disclosure and an alleged fraud” stemming from mismanagement is too attenuated to give rise to a claim under the Exchange Act’s antifraud provisions.¹⁹⁴

Although Congress’s role in the development of antifraud causes of action was relatively limited prior to SOA, both the SEC and the courts have been active in shaping jurisprudence in this area.¹⁹⁵ The Supreme Court, at times, has granted deference to the SEC on issues of implementation of Section 10(b) and Rule 10b-5, although the future of Rule 10b-5 jurisprudence is not certain.¹⁹⁶ On the other hand, the Court has, at times, rejected the SEC’s view of the requirements of Rule 10b-5 in connection with insider trading lawsuits, although more recently the Court has accepted the SEC’s views in this area.¹⁹⁷

Moreover, and more importantly, the Court may look to how the SEC has interpreted Rule 10b-5 in similar cases and whether Congress has attempted to rein in the SEC.¹⁹⁸ The SEC has concerned itself with corporate governance and standards of director behavior as those concepts are related to development of an efficient disclosure regime and of well-functioning capital markets.¹⁹⁹ Indeed, the SEC expressed concern about the “development of disclosure standards adequate for

¹⁹² Joan M. Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, FORDHAM J. OF CORP. & FIN. L. 225, 254-55 (2005).

¹⁹³ Stephen J. Choi and A.C. Pritchard, *SECURITIES REGULATION: CASES AND ANALYSIS* 20 (Foundation Press 2005).

¹⁹⁴ See Mills, *supra* note 83, at 497-98.

¹⁹⁵ Choi and Pritchard, *supra* note 193 at 464.

¹⁹⁶ Contrast traditional misappropriation theories versus misappropriation theories of insider trading under 10b-5, for example. Another example is the use of the efficient capital markets hypothesis and fraud-on-the-market theory.

¹⁹⁷ This may be due to a perceived need to protect the investing public, a need that was apparently on the minds of members of Congress, as well as on the minds of the investing public, following the recent accounting frauds.

¹⁹⁸ See *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000).

¹⁹⁹ See Mills, *supra* note 83, at 489.

informed appraisal of management's ability and integrity" in *In re Franchard*.²⁰⁰

In *Franchard*, the SEC considered two main factors: its own powers under the Securities Act and practicalities of administering the Exchange Act. The SEC distinguished directors' due diligence in the preparation of SEC filings (in this case a registration statement as required by Section 11 of the Securities Act) versus directors' due care in the "ordinary operations of business enterprises[.]"²⁰¹ The SEC asserted that diligence exercised in the former context is evaluated under federal securities law; diligence exercised in the latter context is evaluated under state statutory and common law of corporate fiduciary duty.²⁰² Moreover, "[t]he [Securities] Act does not purport[] . . . to define Federal standards of directors' responsibility in the ordinary operations of business enterprises[.]" and the SEC has no power to "formulate administratively such regulatory standards."²⁰³ In other words, state law, not federal securities law, determines standards of director behavior in conducting ordinary business operations.

Furthermore, to require routine disclosures as to whether or not the directors performed their state law fiduciary duties also would require the SEC to determine whether an assertion that directors complied with their state law fiduciary duties was a material truth or a material misrepresentation. This would require the SEC to undertake its own evaluation of whether the directors met their duty of care. Whether or not directors have met their duties varies given the complexity and type of business decision. Due to this complexity, courts are loathe to interfere with directors' business judgments and to find that the directors should be liable for breach of due care. Similarly, the SEC was reluctant to take on the administrative burden of determining rights and liabilities for state law breach of fiduciary duty claims.

Although the SEC expressed reluctance to determine whether directors acted as careful fiduciaries, it did leave the door open to make such determinations. Because the Court may be guided by an administrative agency's own interpretations of its powers, the Court may grant deference to the SEC on this issue.

²⁰⁰ *In re Franchard Corporation*, No. 4710, 1964 WL 67454, at *5 (July 31, 1964).

²⁰¹ *Id.* at *9.

²⁰² *Id.* at *8.

²⁰³ *Id.* at *9.

1122 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

Congress granted the SEC's Division of Enforcement additional resources in SOA,²⁰⁴ indicating that Congress intended that the SEC take an expanded role in enforcing federal law against accounting fraud.²⁰⁵

The U.S. Supreme Court addressed whether a claim by minority shareholders alleging an inadequate price for their shares in a cash-out merger stated a claim under Section 10(b) of the Exchange Act.²⁰⁶ The Court stated that Section 10(b) was meant to reach manipulative and deceptive conduct. Because the complaint did not allege a material misrepresentation or omission in connection with the merger transaction, the Court held that the complaint fell outside of the scope of Section 10(b). Moreover, the court cautioned that the claim that the merger resulted in an unfair price to the minority shareholders was typically a matter for state courts to decide and declined to extend the scope of Rule 10b-5 to cover situations where shareholders were dissatisfied with share price, but no deceit was involved. The Court declined to take that step absent clear congressional intent to federalize state law governing director responsibilities.

In spite of the broad language in *Santa Fe v. Green*, and arguments based on that language that there is no federal common law cause of action for breach of fiduciary duty after *Santa Fe*, the principles enunciated by the Court should not exclude federal liability if directors fail in their duties and a violation of Section 10(b) results. It is more precise to note that the Court stated that Congress did not intend to regulate acts which "constitute no more than internal corporate mismanagement[.]"²⁰⁷ The federal proceedings based on failure to monitor and oversee involve fraud and knowledge of fraud; more than internal corporate mismanagement is at issue.

Santa Fe does not address the issues raised by the *Chancellor* case. Therefore, the Court once again may be called on to interpret the reach of Section 10(b) and Rule 10b-5. However, the Supreme Court might not grant *certiorari* in such a case. The Court has had opportunities to resolve

²⁰⁴ See generally Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7504-7266, 78o-6, 78d-3, 18 U.S.C. §§ 1348-1350, 1514A, 1519-1520 (Supp. 2006).

²⁰⁵ SOA tracks very closely to Enron fraud, but does not create new penalties or sanctions against failure to oversee. See *supra* note 189 and accompanying text.

²⁰⁶ See *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

²⁰⁷ *Santa Fe*, 430 U.S. at 478.

a split among the Circuits with regard to the level of scienter required under Rule 10b-5.²⁰⁸ Nonetheless, the Court has declined to do so.

B. The Burden of Proof

The burden of proof has two definitions: (1) the burden to produce enough evidence to satisfy the fact finder of a particular fact in issue and (2) persuading the fact finder that the alleged fact is true.²⁰⁹ The second definition is sometimes known as the burden of persuasion. The SEC bears the burden of persuasion on the underlying violation, on the question of unfitness, and on whether a temporary or permanent bar order is the appropriate remedy.

The standard of proof alerts the fact finder as to who bears what proportion of the risk of a mistaken judgment—plaintiff or defendant. Three standards of proof may apply—preponderance of the evidence, clear and convincing evidence, and evidence beyond a reasonable doubt. A preponderance of the evidence is the appropriate burden of persuasion for SEC bar actions in both administrative proceedings and in federal court actions, for at least two reasons. First, “the term ‘unfitness[]’ was intended to suggest a lower standard of proof than the previous standard under the Remedies Act.”²¹⁰ The change from the “substantial unfitness” standard to an “unfitness” standard was intended to lower the SEC’s burden of persuasion. Finally, the change in standard may be seen as a message to courts to impose bars in cases of egregious conduct and that a finding of the likelihood of future misconduct is not the factor that should carry the most weight. Secondly, preponderance is the standard most often imposed in civil proceedings, in private plaintiff Section 10(b) lawsuits, and in administrative proceedings to bar regulated professionals.

²⁰⁸ Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1090 n.5 (1991).

²⁰⁹ C. J. Cuevas, *Rule 10b-5 and Burdens of Persuasion: A Preponderance is Enough*, 12 CAP. U. L. REV. 495, 510 n.92 (1983).

²¹⁰ Barnard, *supra* note 78, at 20; *see also* S. REP. NO. 107-205, at 27 (2002).

The Commission has argued that the ‘substantial unfitness’ standard for imposing bars is inordinately high, causing courts to refrain from imposing bars even in cases of egregious misconduct. The proposed bill rectifies this deficiency by modifying the standard governing imposition of officer and director bars from ‘substantial unfitness’ to ‘unfitness.’

S. REP. NO. 107-205, at 27; *see also supra* note 11.

C. *Providing Proper Directorial Incentives*

Another set of challenges arises from the practical and political implications of such lawsuits. First, as a matter of law, directors are not expected to know (and as a practical matter are not likely to know) the detailed workings of a large corporation. Regulation, whether by formal rulemaking or by reports, and administrative and civil proceedings must not chill interested and qualified persons from serving as non-management directors on corporate boards, but must provide a restraint on less circumspect corporate behavior. Whereas the SEC may be able to recognize reckless ignorance of accounting fraud when it sees it, non-management directors may not know how much they should know about corporate financial information and the decisions that produce such information from raw data. Regulation should encourage corporate boards, and especially non-management directors, to continue the best practices catalyzed by SOA.

A growing wave of criticism of SOA provisions by corporations and legislatures indicates a backlash against federal regulation of corporate governance. Although SOA has always had its critics, more critics have become more vocal. Such critics argue that SOA was an inappropriate and inefficient response, and that SOA has harmed more than it has served to benefit the economy. Regardless of one's views as to the merits of that argument, it remains true that Congress's reaction was swift, and that corporate officials were concerned with the potential liability created by many of SOA's provisions. Some officials reacted by leaving their positions. Potential corporate directors have refused to take directorial positions because of concerns about future liability, while others face an increased due diligence burden in deciding whether they would accept positions on corporate boards. Director and officer liability insurance costs have reached a high not seen since the Delaware Supreme Court's decision in *Smith v. Van Gorkom* defined a standard of personal liability for corporate directors that exposed directors to liability for behavior formerly seen as meeting the legal standard of due care. In the current atmosphere of uncertainty, additional concerns are raised if the SEC increases its enforcement efforts against non-management directors. Such concerns include whether the SEC would exercise its prosecutorial discretion to bring administrative proceedings and civil suits against directors who thought their behavior met the standard of care under state law.

However, the recent cases reveal a trend toward holding directors accountable for behavior that likely would breach state fiduciary duties

as well as amount to federal securities fraud. Even directors who are unsure of what conduct satisfies state fiduciary duties (at a minimum) and of what exemplifies best practices would know that falsifying documents constitutes fraud. Audit committee members should realize that they have a responsibility to investigate red flags raised by outside auditors, under both state and federal law. Directors are not required to know the details of daily operations (micro-monitoring) in order to avoid liability. Further, the SEC has indicated that a hands-off approach in the face of known red flags (under monitoring) may lead to liability.

D. Is the SEC Fit to Serve in this Watchdog Role?

One recent article noted that "Sarbanes-Oxley arguably fills the statutory gap left by the 1933 and 1934 Acts, which may not have provided enough of a statutory basis for the SEC to pursue directors who breached their fiduciary duties."²¹¹ In this regard, SOA may indicate Congress's intent to empower the SEC to bring administrative and civil court proceedings to bar officers and directors from serving in such capacities in publicly-traded companies.²¹²

Indeed, SOA falls short of its real potential to enforce standards of director care at the federal level. However, this shortcoming may reflect Congress's desire (influenced by the SEC) to defer to the SEC to curtail accounting fraud. In the past, the SEC has expressed a reluctance to bring actions against directors, particularly non-management directors, for failure to monitor and investigate. However, to the extent that lack of resources and enforcement options thwarted the SEC's enforcement efforts, SOA mitigates the problems to a degree. Congress gave the SEC more resources to do its job and provided enhanced enforcement remedies to aid the SEC in its enforcement efforts. Also, the SEC has additional support from the enhanced monitoring function of other watchdogs, particularly outside accounting firms. For example, outside accounting firms uncovered and alerted the SEC to the accounting frauds at *Chancellor*, *Del Global*, and *Candie's*.²¹³

Should the SEC prove to be an ineffective watchdog, others, such as state courts and outside auditors, may provide more vigorous checks on accounting fraud. Finally, some commentators have suggested that Congress can step in and amend SOA to include a federal fiduciary duty

²¹¹ See Mills, *supra* note 83, at 486 (citing Peloso & Indek, *supra* note 190, at 3).

²¹² See Mills, *supra* note 83, at 487. In addition, the standard in Sarbanes-Oxley is unfitness, as opposed to the substantial unfitness standard. See *supra* note 11.

²¹³ See Sale, *supra* note 21, at 1402.

1126 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 42]

rule, should the SEC prove to be an ineffective watchdog. Of course, the political will may be absent in Congress in any given election year, given that a series of financial frauds and accounting meltdowns the size of Enron, WorldCom, and Waste Management has not occurred since the beginning of this century.

VI. CONCLUSION

Corporate governance flaws of the kind identified in this article are not a new phenomenon.²¹⁴ Recent scandals involving widespread backdating of options for both management and non-management directors, pretexting, and accounting fraud indicate that the monitoring and oversight failures present at the beginning of this century still exist and are likely as pervasive as they were at that time.²¹⁵ Further, recent federal regulation, including SOA and the stock exchange listing rules, does not create new civil or criminal liabilities for corporate directors, with a few exceptions.²¹⁶ Chief executive officers and chief financial officers, who are also likely to be directors, do face additional, express requirements to certify the truth and accuracy of financial statements filed with the SEC.²¹⁷ However, various legal theories existed prior to SOA under which corporate officers may have been found liable for knowingly signing false financial statements.²¹⁸ Furthermore, not every corporate director must sign SEC filings. Under SOA, non-management directors do not face express, new liability for failure to monitor and oversee corporate activities. In that sense, SOA failed to take the step

²¹⁴ This is not a case of "if it is not broken, do not fix it."

²¹⁵ Enron and WorldCom have come to epitomize financial and accounting fraud and the lack of director perception of that fraud, in part due to director inattention. *See generally supra* notes 26, 105 and accompanying text. Hewlett-Packard has become the "poster child" to illustrate pretexting—an investigative practice involving gathering confidential information through the use of invented stories. *See House Panel Digs Deep in HP Spy Case*, WASH. POST, Sept. 29, 2006. Hewlett-Packard's former board chair, Patricia Dunn, former general counsel Ann Baskins, and former chief ethics officer Kevin Hunsacker resigned after it was revealed that they had used pretexting to determine the source of a board leak of confidential information regarding Hewlett-Packard's long-term strategic plans. *Id.* (The source was Hewlett-Packard board member George Keyworth.) Whole Foods and the SEC are investigating Whole Foods's Chief Executive Officer John Mackey's anonymous internet postings attacking rival Wild Oats as a "bad business not worth its stock price." *See Whole Foods CEO's Anonymous Online Life*, ASSOCIATED PRESS, July 12, 2007, available at <http://www.msnbc.msn.com/id/19718742/>. Whole Foods later attempted to purchase Wild Oats. *Id.* In time, HP and Whole Foods's behaviors may come to be seen as hubris, underestimation of risk, overconfidence, or another type of cognitive bias.

²¹⁶ *See supra* note 33 and accompanying text.

²¹⁷ *See supra* note 33 and accompanying text.

²¹⁸ *See generally* Fairfax, *supra* note 25.

that would provide a more direct route to liability for failure to oversee corporate operations.

Courts and the SEC “should approach the question of ‘unfitness’ guided by principle and with humility.”²¹⁹ But more importantly, courts and the SEC should recognize that accounting and financial fraud threaten the public welfare.²²⁰ To the extent that courts have been reluctant to impose prospective bars, they also should keep in mind that Congress lowered the unfitness bar to facilitate “the SEC’s prevention of individuals who have violated the securities laws from serving as officers and directors[]” and to “reflect the President’s recommendation that ‘CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.’”²²¹ Only egregious failure to heed red flags should give rise to civil monetary liability in the new regime.²²² Cases involving management ignorance of “flagrant misdeeds, management self-interest[,] and repeated red flags[]”²²³ provide a sound model for future SEC enforcement actions and bar remedies.

²¹⁹ See Barnard, *supra* note 78, at 13.

²²⁰ See Justin Toby McDonald, *An Historical Perspective to the Corporate Bar Provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, 49 WASH. & LEE L. REV. 987, 1021 (1992).

²²¹ S. REP. NO. 107-205, at 26-27 (2002).

²²² See Mills, *supra* note 83, at 492 (“At present[,] [federal regulators] are able to develop a federal fiduciary duty standard on an ad hoc basis, selecting egregious cases that tend to result in a standard that is both flexible and harsh.”).

²²³ See Mills, *supra* note 83, at 495.