VII.
Potential Liability of Audit Committee Members

The increased public focus on audit committees significantly increases the risk of lawsuits (including both regulatory claims by the SEC seeking statutory fines, penalties and remedial measures, and private lawsuits seeking monetary damages), SEC injunctive actions, administrative cease and desist orders, and, in appropriate cases, criminal prosecution.

Arguments can be made that neither Sarbanes-Oxley, nor the SEC implementing rules,[1] nor any Dodd-Frank Act provisions significantly increase the personal risk of audit committee members, who were signing Form 10-K reports containing audited financial statements before the enactment of that legislation. The members of the audit committee as such are not required to sign any SEC filings, except that the Form 10-K requires the signature of the majority of the members of the board of directors.[2] However, these arguments, even if technically accurate, miss the point.

Given the current regulatory and media environment, there simply is a much greater likelihood today that civil and criminal actions will in fact be brought against audit committee members than ever before. Sarbanes-Oxley merely focused a public spotlight on the audit committee. This spotlight, in turn, causes government enforcers and private litigants to focus on the role of the audit committee any time there is a public revelation of abusive accounting practices, particularly where these abusive practices caused significant investor losses. Any time there is a financial fiasco, the role of audit committee members will be examined under the microscope with the advantage of 20/20 hindsight.

Thus, whether or not Sarbanes-Oxley actually results in additional individual liability for audit committee members, there is a much higher risk of government and private litigation actions against them than ever before. Indeed, this risk has already been manifested by numerous high-profile government and private actions that have captured the attention of the financial media following the Enron and WorldCom financial disasters. Despite these high profile cases, during the last decade the number of actual SEC enforcement actions as opposed to private cases against directors (including audit committee members) have been relatively sporadic and limited to egregious factual situations.

The legal doctrines described in this chapter for imposing audit committee member liability give significant discretion to judges in interpreting these doctrines and applying them to the specific facts of individual cases. It should be expected that a judge who is outraged over corporate corruption scandals will tend to err on the side of imposing liability in borderline cases where the issues are closely balanced.

Finally, audit committee members should be concerned about the November 18, 2002, decision of the U.S. District Court for the District of Massachusetts entitled *In re Lernout and Hauspie Securities Litigation*.[4] The court in *Lernout* imposed control person liability under § 15 of the 1933 Act and § 20(a) of the 1934 Act on audit committee members in connection with a massive financial fraud case while at the same time dismissing similar allegations against directors who were not audit committee members.[5] The *Lernout* case is discussed in *Federal Securities Law and Control-Person Liability*, 49 CPS § VII-C.

Audit committees that are concerned about satisfying their duties and about attempting to reduce the risk of personal liability should seriously consider engaging an experienced special audit committee counsel to advise them. If a special counsel is engaged, then the counsel should be experienced in advising other audit committees in securities law and regulation, with an adequate accounting background. The audit committee should also consider whether or not any counsel chosen would have to satisfy the same independence tests (if any) which apply to audit committee members.

This chapter discusses the potential civil liability of members of an audit committee. As noted, in addition to such civil liability, audit committee members can be subjected to civil injunctive actions and administrative cease and desist orders by the SEC. In appropriate cases, criminal sanctions can be sought. Section VII-A discusses state law fiduciary duty theories, 49 CPS § VII-B reviews the concept of differential liability under both state law and federal securities law, 49 CPS § VII-C discusses the case law on audit committee members as ‘‘control persons’’ under federal securities law, 49 CPS § VII-D discusses the signature requirement, 49 CPS § VII-E considers the effect of the SEC and major stock market rules, 49 CPS § VII-F discusses enforcement actions against audit committee members, and 49 CPS 49 CPS § VII-G reviews methods for insulating directors from potential liability as audit committee members.

A. State Law Fiduciary Duties

State law imposes various fiduciary duties on all directors, whether or not the directors are members of audit committees. The most important of these duties are the duties of due care and loyalty. In Delaware, the courts have also imposed a duty of candor.[6] The duty of care can be eliminated.[7]

The American Law Institute Principles of Corporate Governance characterizes the following statement as the ‘‘black letter law’’ consistent with the duty of care standards articulated in most jurisdictions today:

> § 4.01 Duty of Care of Directors and Officers; the Business Judgment Rule
>
> (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person

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[1] See *Response of the SEC to the Blue Ribbon Committee and COSO Reports: 1999 to 2001*, 49 CPS § VIII-E.

[2] *See* Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000) (explaining that a corporate officer who signs an SEC filing containing representations ‘‘makes’’ the statement in the filing and can be liable as a primary violator of § 10(b) of the Exchange Act).

[4] 286 B.R. 33 (Bankr. D. Mass. 2002).

[5] *See id.*

[6] Stroud v. Grace, 606 A.2d 75, 85 (Del. 1992); *see generally* R. Franklin Balotti & Jesse Finkelstein, The Delaware Law of Corporations and Business Organizations § 22.1 (3d ed. 1999).

[7] See *Elimination of duty of due care*, § VII-G2.

would reasonably be expected to exercise in a like position and under similar circumstances. This subsection (a) is subject to the provisions of subsection (c) (the business judgment rule) where applicable.

(1) The duty in subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefore. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.

(2) In performing any of his or her functions (including oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02 and 4.03 (reliance on directors, officers, employees, experts, other persons, and committees of the board).

(b) Except as otherwise provided by statute or by a standard of the corporation [§ 1.36] and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling the duty under this Section with respect to any delegated function if the reliance is in accordance with §§ 4.02 and 4.03.

(c) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:

(1) is not interested [§ 1.23] in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.[8]

The Delaware courts have been especially critical of directors who fail to keep themselves fully informed and to critically assess information provided to them by management. Members of audit committees are particularly susceptible to charges that they failed to keep themselves fully informed and to exercise proper skepticism. Indeed, one of the major functions of the audit committee is to help protect the corporation against improper accounting practices by management. In addition, other directors of the corporation are permitted to rely on the audit committee to have properly performed its delegated duties.[9]

Two prominent Delaware cases illustrate the need for directors to remain fully informed and to assess management critically. Both cases arose in the context of a merger or tender offer, but their principles are equally applicable outside of that context.

Smith v. Van Gorkom involved a shareholder class action seeking rescission of a cash-out merger of the corporation into a new corporation or, alternatively, damages against the directors and others.[10] The Delaware Supreme Court determined the duty of candor was breached by the directors' "failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval." [11] The court also made the following observation about the duty of directors to be informed:

> Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment." A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.[12]

The court in *Van Gorkom* ultimately concluded that the directors breached their affirmative duty to inform themselves of all information reasonably available to them and relevant to their decision to approve the merger.[13]

Paramount Communications Inc. v. QVC Network, Inc. involved a two-tiered, front-end loaded tender offer.[14] The Delaware Supreme Court held that the target's directors breached their fiduciary duties by, among other things, choosing "to wall themselves off from material information which was reasonably available." [15] The court again emphasized the directors' duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.

Following *Van Gorkom* and its progeny, it is expected that directors will have complete access to all of the information

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[8] *See* AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (prepublication ed. 1994) (recognizing good faith reliance) [hereinafter ALI PRINCIPLES].

[9] *See id* at ¶ 4.01(b).

[10] 488 A.2d 858 (Del. 1985), *superseded by stat. on other grounds*.

[11] *Id.* at 893.

[12] *Id.* at 872 (citations omitted).

[13] *Id.* at 893.

[14] Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).

[15] *Id.* at 51.

and material upon which their decision is based in order to discharge properly their fiduciary duty of care.[16] For members of an audit committee, adherence to these principles is often complicated by their need to rely on outside experts to distill the mass of available information into a manageable report. To address this issue, Delaware, in certain circumstances, has provided a safe harbor for directors who base their decision on information provided by an expert or professional in § 141(e) of the Delaware General Corporation Law.[17] To avail oneself of this protection and to preclude a breach of the duty of care, the information upon which the directors rely must be provided by ''an expert 'selected with reasonable care' '' and be ''within that person's 'professional or expert competence.' '' [18] Accordingly, members of an audit committee should actively participate in the selection of the independent professionals upon whose advice they will rely in order to ensure the applicability of § 141(e)'s safe harbor provision.

In addition to the liability associated with a director's failure to remain fully informed before acting on an issue before the board, the duty of care also imposes on directors an affirmative duty to monitor the ongoing operation of the corporation's business.[19] The obligation to implement a corporate reporting system recognizes the need for relevant and timely information as an essential predicate for satisfaction of the board's supervisory role under § 141 of the Delaware General Corporation Law.[20] A thorough discussion of the relationship between fulfilling one's duty of care and the obligation to actively gather accurate information can be found in the seminal case of *In re Caremark International, Inc.*[21]

In *Caremark*, the Delaware Court of Chancery was faced with a board that had failed to unearth pervasive and illegal practices utilized by the corporation's employees that resulted in Caremark being charged with multiple felonies under state and federal law.[22] Recognizing that liability can attach to a board's unconsidered failure to act, the court identified the need for boards to affirmatively employ a corporate information and reporting system which is in concept and design adequate to assure that appropriate information will come to the board's attention in a ''timely manner'' and ''as a matter of ordinary operations.'' [23] The failure to implement such a system could result in the board failing to satisfy its responsibilities and render the directors liable for the losses suffered by the corporation.[24] Given the responsibilities of audit committees to oversee the accuracy of their company's financial reporting system, the implications of the *Caremark* decision on the liability of audit committee members is evident. Moreover, the crucial role of the audit committee in corporate governance may make its members more susceptible to claims of breach of fiduciary duties than members of other less important committees.[25]

B. Differential Liability

In his famous opinion of *Dovey v. Corey*, Lord Halsbury held that a director could not be held responsible for accounting functions if they had been delegated and the director had relied on the delegatees in good faith.[26] However, this general proposition is probably eviscerated by the establishment of an audit committee involving: ''(1) assumption by the board of duties in addition to those traditionally held by corporate directors, and (2) delegation of such assumed duties to the audit committee.'' [27]

> **Note**: One of the consequences of this assumption of additional duties has been the emergence of a standard of differential liability. Essentially, this principle recognizes an increased responsibility and potential liability for a director who has a special background, expertise, or who assumes any special duties as a board member.[28] Under this standard, such a director is obliged to inquire, learn, and act affirmatively upon matters within the limits of his or her responsibilities.
>
> **Caution**: It is increasingly likely that expertise or knowledge in and of itself will be sufficient to impose legal liability.[29] This standard probably will be applied if audit committee members are inactive or fail to exercise their responsibilities. Those who fail to learn and act upon that which they reasonably could have learned and acted upon are most susceptible to liability.[30]

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[16] Moore Bus. Forms, Inc. v. Cordant Holdings Corp., No. 13911, 1998 WL 71836, at *7 (Del. Ch. Mar. 5, 1998).

[17] DEL. CODE ANN. tit. 8, § 141(e).

[18] *In re*Cheyenne Software, Inc. S'holders Litig., No. 14941, 1996 WL 652765, at *2 (Del. Ch. Nov. 7, 1996).

[19] *In re*Caremark Int'l, Inc., Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

[20] *Id.* at 970.

[21] *Caremark*, 698 A.2d 959; *see also* Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[22] *Caremark*, 698 A.2d 959, 960.

[23] *Id.* at 970.

[24] *Id.*

[25] Syracuse Television Inc. v. Channel 9, 273 N.Y.S.2d 16 (N.Y. Sup. Ct. 1966) (holding that independent directors on a company's audit committee may be held to an ''intermediate'' standard of care that is more rigorous than that applied to outside directors who do not serve on important committees, but less rigorous than that applied to inside directors); *see also* John F. Olson, *Special Fiduciary Duties of Audit Committee Members*, *Presentation Prepared for Director's Liability: Understanding Today's Responsibilities* (Dec. 7, 1995), *in* Beth Duncan, *Audit Committee Members May Face Heightened Liability, But Independence, Committee Charter, May Limit Exposure*, BNA'S CORP. COUNS. WKLY., Dec. 20, 1995, at 8.

[26] [1901] App. Cas. 477, 485–86; *accord* Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924), wherein Judge Learned Hand acknowledged that a director could be discharged of a responsibility by delegating it to others because ''[t]o hold otherwise is practically to charge him with detailed supervision of the business which, consistently carried out, would have taken most of his time.'' *See Barnes*, 298 F. 614, 620. This led Judge Hand to conclude that ''if a director must go so far as that, there will be no directors.'' *Id.* at 620.

[27] ABA Overview Committee's Report, at 1859–60 (1979). Indeed, there is some common law authority for the proposition that outside directors who serve on a board committee may be held to a higher standard of responsibility, and hence a higher standard of liability, than outsiders who do not serve on the committee. *See also Syracuse Television*, 273 N.Y.S. 16.

[28] ABA Overview Committee's Report, *supra* note 27, at 1859.

[29] *See, e.g.*, Greenfield v. Prof'l Care, Inc., 677 F. Supp. 110 (E.D.N.Y. 1987).

[30] *See, e.g., id.*; *see also* Olson, *supra* note 25 at 8; Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held*

1. *State law and differential liability*

The duties and liabilities of directors are still primarily governed by state law. Most states, like California [31] and New York,[32] have legislatively endorsed the doctrine of differential liability. These statutes are similar in that they both provide that a director who is not a committee member can rely upon information prepared or presented by a committee when such information is within the committee's designated authority, the director believes the committee merits confidence, and the director acts in good faith and without knowledge that would cause his or her reliance to be unwarranted.[33]

> **Comment**: As a practical matter, these statutes may shield nonmembers of the committee from liability for activities within the scope of the audit committee's responsibilities. In contrast, however, they may increase the potential liabilities of audit committee members. This illustrates the necessity for adequately setting forth the functions and responsibilities of the audit committee in written form. Such a document not only advises committee members of the matters for which they will be held responsible, but also puts nonmembers on notice of the functions for which they may rely on the audit committee.[34]

The drafting of the charter of the audit committee or a description of its functions requires a careful balance of the interest of the members of the committee with the members of the rest of the board. The broader the audit committee's charter, the greater the potential liability of the audit committee members and the greater the immunity and potential contribution rights of the balance of the board members against the audit committee members. Conversely, a narrow audit committee charter protects audit committee members, but increases the potential liability of remaining board members.

The ALI Principles of Corporate Governance contains the following comment under § 4.01:

> The terms ''good faith,'' ''reasonably believes,'' and ''like position,'' in § 4.01(a), recognize that in determining whether reasonable care has been exercised, the special skills, background, or expertise of a director or officer are properly accorded weight. Special skills (e.g., in engineering, accounting, or law) may, for example, alert a director to a significant corporate problem before other directors would recognize it. Such a director, being obliged to act in the best interests of the corporation, cannot reasonably ignore this knowledge. The *Corporate Director's Guidebook* (p. 1601) ''recognizes that the special background and qualifications of a particular director . . . may place greater responsibility on that director.'' [35]

2. *Federal securities law and differential liability*

Those serving as audit committee members also face the potential for increased liability under the federal securities laws. The differential liability standard has been applied by judicial interpretations of both § 11 of the Securities Act of 1933 (the Securities Act) [36] and § 10(b) of the Securities Exchange Act of 1934 (the Exchange Act).[37] For the most part, these decisions differentiate between inside and outside directors; however, they would appear to have equal applicability to directors who assume the unique duties associated with the audit committee.[38]

The leading case applying the differential liability standard is *Escott v. BarChris Construction Corp.*[39] In its analysis of the circumstances under which a director can raise a due diligence defense, the court stated that the director must establish that he or she conducted a reasonable investigation into his or her areas of responsibility, and that after such investigation, had reasonable grounds to believe, and did in fact believe, in the accuracy of the information reviewed. The court then defined ''reasonableness'' in terms of a reasonably prudent person managing his or her own property.[40] More importantly, however, the court applied that standard in terms of differential liability. That is, those with a particular expertise and access to information were held to a higher standard.[41]

Other courts applying *BarChris* have also viewed the standard in terms of differential liability. As one court stated:

> What constitutes ''reasonable investigation'' and a ''reasonable ground to believe'' will vary with the

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Corporation, 31 Bus. Law. 1799, 1814 (1976).

[31] Cal. Corp. Code § 309.

[32] N.Y. Bus. Corp. Law § 717.

[33] Am. Bar Ass'n, Revised Model Bus. Corp. Act §§ 8.30, 8.30(d) (revised through 2012), *reprinted in* 49 CPS Practice Tool 14.

[34] Edward F. Greene & Bernard B. Falk, *The Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of Its Objectives and Functions*, 34 Bus. Law. 1229, 1248 (1979).

[35] ALI Principles, *supra* note 8, at § 401, cmt. to § 401(a), ¶ 1.

[36] 15 U.S.C. § 77k(a).

[37] *Id.* § 78j(b).

[38] It has been posited that establishing an audit committee can result in three different standards of director liability. *See* Greene & Falk, *supra* note 34, at 1247–48. Inside directors would be held to the highest standard, while outside directors who do not serve on audit committees would be held to the lowest standard. Somewhere between the two poles would stand outside directors who serve on audit committees. As the authors stated:

> By virtue of the knowledge of corporate financial affairs which they acquire, or are expected to acquire, as a result of their membership on the Audit Committee, outside directors serving on the Committee may be held to a higher standard than outside directors not serving on the Committee; but the standard of Committee members will probably be lower than that of inside directors who, because of their day-to-day involvement with the operations of the company, have an even greater knowledge of corporate affairs.

Id.

[39] 283 F. Supp. 643 (S.D.N.Y. 1968).

[40] *Id.* at 688–92. The court applied the standard of care set forth in § 11(c) of the Securities Act. Section 11(c) provides as follows: ''In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.'' *Id.*

[41] *BarChris*, 283 F. Supp. 643, 688–92; *see also* Syracuse Television Inc. v. Channel 9, 273 N.Y.S.2d 16 (N.Y. Sup. Ct. 1966).

> degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions.[42]

Moreover, there is also support in the legislative history of the Securities Act for this proposition. According to a report on the bill that became the Securities Act, the duty of care varies with the importance of the person and the degree of protection the public has a right to expect from him or her.[43]

C. Federal Securities Law and Control-Person Liability

Control persons of a corporation have potential personal liability under § 15 of the Securities Act [44] and § 20(a) of the Exchange Act [45] for corporate acts violating those laws. Is being on the audit committee an indication of a control relationship with the corporation?

Section 15 of the 1933 Act reads as follows:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under Section 11, or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.*[46]

Section 20(a) of the 1934 Act reads as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.*[47]

According to Professors Loss and Seligman, the differences in the defenses to control person liability of these two sections is ''unexplained'' and is ''more remarkable—and the more exasperating—in view of the fact that § 15 of the 1933 Act as originally enacted contained no defense at all.'' [48] Notwithstanding the difference in wording, many courts view §§ 15 and 20(a) as ''analogues'' and give them the same interpretation.[49] According to the court in the *Enron* case:

> Furthermore, under Fifth Circuit precedent, while lack of participation and good faith constitutes an affirmative defense to one charged with controlling person liability under either federal Act, the plaintiff has the burden of establishing control, while the defendant must prove good faith. Thus for a *prima facie* case of controlling person liability, a plaintiff is not required to plead facts showing that the defendant acted in bad faith.[50]

Although the Fifth Circuit, the Seventh Circuit, the Eighth Circuit, the Ninth Circuit, the Tenth Circuit, and the Eleventh Circuit do not require the plaintiff to plead facts showing bad faith, a number of other circuits, such as the Second, Third, and Fourth, have held that the controlling person must be a culpable participant in the alleged violation.[51] Professors Loss and Seligman consider this culpable participation requirement to be an ''unsettled question.'' [52]

The ''good faith'' defense to audit committee control liability is likely to require more than passive good faith and would likely not be satisfied by reckless conduct of an audit committee member who ignored obvious ''red flags.'' Accordingly, the authors have used the words ''due diligence'' defense to describe the defense to liability of the audit committee under §§ 15 and 20(a). The inability to use passive good faith as a defense is best illustrated by the *Lernout* case discussed below.[53]

Lernout involved a class action containing securities fraud claims against an outside board of directors, including the audit committee, of a bankrupt speech recognition software corporation, Lernout & Hauspie Speech Products, N.V. (L & H).[54] The proposed class action alleged ''that the Audit Committee was asleep at the switch, recklessly so, and failed to catch the massive fraud by L & H's Senior Officers and auditors.'' [55] The chairman of the audit committee allegedly signed a Form S-3 registration statement filed by L & H on Aug. 25, 2000, which publicly incorporated an allegedly fraudulent 1999 Form 10-K

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[42] Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 577–78 (E.D.N.Y. 1971); *see also* Greenfield v. Prof'l Care, Inc., 677 F. Supp. 110 (E.D.N.Y. 1987) (denying a motion to dismiss securities fraud claims against outside directors serving on the company's audit committee); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Blakely v. Lisac, 357 F. Supp. 255 (D. Or. 1972) (applying the differential liability standard under § 10(b)).

[43] H.R. Rep. No. 73-85 (1933); *see also Feit*, 332 F. Supp. 544, 578.

[44] 15 U.S.C. § 77o.

[45] *Id.* § 78t.

[46] *Id.* § 77o (emphasis added).

[47] *Id.* § 78t (emphasis added).

[48] Louis Loss & Joel Seligman, Securities Regulation 4468 (3d ed. 2002).

[49] G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958 & n.23 (5th Cir. 1981).

[50] *In re*Enron Corp. Sec., Derivative & ERISA Litig., 258 F. Supp. 2d 576, 598 (S.D. Tex. 2003) (citations omitted).

[51] *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990); G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 957–59 (5th Cir. 1981); Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394 (4th Cir. 1979); Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 889–90 (3d Cir. 1975); Lapin v. Goldman Sachs Group, Inc., 506 F. Supp. 2d 221 (S.D.N.Y. 2006).

[52] Loss & Seligman, *supra* note 48, at 4470.

[53] *In re*Lernout & Hauspie Sec. Litig., 286 B.R. 33 (Bankr. D. Mass. 2002).

[54] *Id.*

[55] *Id.* at 36.

report filed on June 20, 2000, which had been signed by all three members of the audit committee.[56]

The court in *Lernout* stated that the following allegations made by the plaintiffs established a strong inference of scienter based on recklessness against the members of the audit committee at least with respect to the fourth quarter financials in 1999 and the annual report for 1999. By the summer 2000, defendant Vanderendriessche, and the audit committee, knew that:

(1) L & H had failed to implement a system of internal audit controls, as KPMG had been persistently recommending since May 1998;

(2) L & H failed to hire an internal auditor until June 2000 despite the Audit Committee's own commitment in August 1999 to get back to the directors with a recommendation;

(3) the Audit Committee promised the Board of Directors that it would meet *prior* to each quarterly financial report to review it and continued to sign off on financial statements in 2000 despite the continuing lack of internal controls and various red flags described below in ¶¶ 4–8;

(4) the SEC was investigating L & H accounting practices in January 2000;

(5) L & H management was issuing financial information in press releases without the advance approval of the Audit Committee;

(6) in reports to the Audit Committee, KPMG continually noted issues concerning cash collection from the LDCs [Language Development Companies, a number of companies that were created by L&H and two companies closely related to L&H] and revenues recognized from Korea, and in a letter dated August 18, 1999, KPMG had reported that at least nine transactions in the Second Quarter of 1999 were questionable;

(7) in a confidential letter, KPMG reported on November 17, 1999 to Vanderdriessche, the chair of the Audit Committee, that it did not consider its "limited review of the third quarter financial statements completed, because of outstanding revenue recognition issues in Korea and cash collection issues from the LDCs"; and

(8) in a different letter from KPMG to Dammekins dated November 17, 1999, which was communicated to Vandendriessche, KPMG advised that it could not sign the audit opinion for the December 31, 1999 audit unless issues relating to outstanding receivables, revenues, and Korean contracts were resolved.[57]

The court held that the signatures on the Form S-3 Registration Statement and the Form 10-K Report satisfied the requirement that the audit committee members "make" a fraudulent statement for purposes of § 10(b) of the 1934 Act.[58] More importantly, the court went on to also hold that, assuming the securities class plaintiffs allegations were correct, the three audit committee members were also control persons and had liability under § 20(a) of the 1934 Act.[59] In refusing to dismiss the control person allegations against the audit committee members, but dismissing these same allegations against non-audit committee members, the Court stated as follows:

> Signatures are one factor supporting a control allegation, but plaintiffs must show signatures plus other indicia of control. *See In re Oxford Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 143 (S.D.N.Y. 1999) (finding that four of the outside directors were control persons based on their director status *combined* with their equity interests in the corporation and their intimate knowledge of the day-to-day operations of the company); *In re Independent Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 772 (S.D.N.Y. 2001) (finding director status plus equity interest plus signature on fraudulent prospectus stated sufficient allegation of control); *In re Valujet, Inc. Sec. Litig.*, 948 F. Supp. 1472, 1480 (N.D. Ga. 1997) (finding outside director who was also founder and signed SEC filing to be control person); *Dequlis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1315 (S.D.N.Y. 1996) (holding that plaintiffs had adequately pled defendants' control and authority by detailing their ability to control the acts of the issuers, their control over the contents of the offering documents as well as their signatures on those documents). In each of these cases, the courts relied both on the special status of the outside director (e.g., audit committee member, equity shareholder) *and* their involvement with the financial statements of the company in finding the director to be a control person.
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> The distinction lies in the director's ability to control the content of the financial documents. Where the director has some special status within the corporation, such as membership on an Audit Committee, and has the power to exercise content control over financial documents, the director's signature on the SEC filing might suffice for pleading purposes to establish the *exercise* of control over the contents of the financial statements. Where the defendant's status is merely that of outside director, however, the defendant's signature on the SEC filing does not necessarily constitute an exercise of any power or control over its contents.[60]

The facts in *Lernout* all occurred before the effective date of Sarbanes-Oxley, although the decision was made during the general public outrage over corporate corruption. Before *Lernout* and Sarbanes-Oxley, there were several attempts made to impose control person liability on audit committee members.

Likewise, before *Lernout*, some courts held that audit committee members who signed a company's financial statements were control persons for purposes of § 20(a) liability because:

[56] *Id.* at 37.

[57] *Id.* at 37–38 (emphasis added) (citations omitted).

[58] *Id.*

[59] *Id.* at 39–40.

[60] *Id.* at 43–44.

> [a]n outside director and audit committee member who is in a position to approve a corporation's financial statements can be presumed to have the power to direct or cause the direction of the management and policies of the corporation, at least insofar as the ''management and policies'' referred to relate to ensuring a measure of accuracy in the contents of company reports and SEC registrations that they actually sign.[61]

In *Haltman v. Aura Systems, Inc.*, the plaintiff in a securities class action lawsuit alleged in its pleadings that Aura had made false and misleading statements in press releases.[62] The action sought to hold Norman Reitman, an outside Aura director and member of the audit committee, personally liable (in addition to other inside and outside directors and officers) for the misstatements under § 20(a) of the Exchange Act. The plaintiff relied on the ''group pleading'' presumption—that ''the officers involved in the day-to-day management of the corporation must be aware of the corporation's internal operations''—in its allegations against Reitman and the other outside directors.[63]

The court held that outside directors such as Reitman may be included within the ''group pleading'' presumption only if the ''outside directors maintained a special relationship with the company such that they may be considered control persons,'' [64] citing *Wool v. Tandem Computers Inc.*[65] The court held that the membership on the audit committee was not in itself sufficient to create a ''special relationship with Aura that would indicate that [Reitman] had direct or indirect control over the conduct of Aura's affairs,'' absent allegations that Reitman's membership on the audit committee ''played a specific role in the creation of the allegedly false and misleading statements.'' [66]

In *Bomarko Inc. v. Hemodynamics, Inc.*, the defendants, who were audit committee members and outside directors, ''successfully rebutted the impression'' that their audit committee membership ''placed them in a position of control.'' [67] The court found that although defendants had participated in a review of a letter from the outside auditor, they ''played no significant role in the management of the corporation or in the dissemination of information . . . said to be misleading.'' [68] Citing *Wool v. Tandem Computers, Inc.*, the court held that there must be some showing of participation in or influence over the company's operations as well as ''actual participation in the activities which allegedly violated the securities laws.'' [69] Merely serving as a director or audit committee member was not enough to establish liability. ''These titles and functions alone do not establish 'controlling person' status.'' [70]

Conversely, *In re First Merchants Acceptance Corp. Securities Litigation* is an example of a holding less favorable to directors who serve on an audit committee.[71] In *First Merchants*, the plaintiffs alleged that audit committee members violated the Securities Act and the Exchange Act by issuing false and misleading financial statements.[72] Specifically, it was argued that the company's Form 10-K filed with the SEC misrepresented that the financial statements ''had been prepared in conformity with generally accepted accounting principles,'' and misrepresented that an outside consultant had audited First Merchants financial statements ''in accordance with generally accepted auditing standards.'' [73] The plaintiffs further alleged that each defendant ''was provided copies of the Company's filings, reports, press releases and other public statements . . . prior to or shortly after their issuance'' and ''had the ability . . . to prevent their issuance or cause them to be corrected.'' [74] These allegations were sufficient to raise the specter of controlling person liability and persuade the court to deny the audit committee defendants' motion to dismiss.[75]

Would Sarbanes-Oxley change these results? The term ''control'' is defined in Rule 12b-2 under the Exchange Act to ''mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'' [76] The enhanced responsibilities and authority given to the audit committee by Sarbanes-Oxley and related SEC and stock market rules significantly strengthen the arguments for control person liability, since these laws and rules empower the audit committee to direct certain of the management and policies of the issuer.

However, the test for control person liability under both *Haltman* and *Bomarko, Inc.* did *not* turn on the responsibilities and authority of the audit committee. Rather, the courts in these

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[61] *In re*Livent Inc. Sec. Litig., 148 F. Supp. 2d 331, 373 (S.D.N.Y. 2001); *see also In re*Reliance Sec. Litig., 135 F. Supp. 2d 480, 518 (D. Del. 2001) (finding that control status was a ''genuine issue of material fact'' when an outside director ''served on subcommitees related to the oversight of [the company's] accounting and reporting practices''); Jacobs v. Coopers & Lybrand, LLP, Fed. Sec. L. Rep. (CCH) ¶ 90,443, 1999 WL 101772, at *18 (S.D.N.Y. 1999) (stating that ''[t]hough his status as a director who allegedly served on the audit committee alone would not raise the inference that Hirsch was a § 20(a) controlling person, the allegation that he signed a fraudulent 10-K form does raise this inference . . . '').

[62] 844 F. Supp. 544 (C.D. Cal. 1993).

[63] *Id.* at 548.

[64] *Id.* at 548–49.

[65] 818 F.2d 1433, 1440 (9th Cir. 1987). Other courts have expressly rejected ''group pleading.'' *See, e.g.*, Zishka v. Am. Pad & Paper Co., 2000 U.S. Dist. LEXIS 13300, at *6–7 (N.D. Tex. Sept. 13, 2000); *In re*Ashworth Sec. Litig., 2000 U.S. Dist. LEXIS 15237, at *34–35 (S.D. Cal. July 18, 2000); Marra v. Tel-Save Holdings, Inc., 1999 U.S. Dist. LEXIS 7303, at *10–16 (E.D. Pa. May 18, 1999).

[66] *Haltman*, 844 F. Supp. 544, 549.

[67] 848 F. Supp. 1335, 1340 (W.D. Mich. 1993).

[68] *Id.*

[69] *Id.* at 1339.

[70] *Id.* (citing Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1442 (9th Cir. 1987)); *see also In re*Livent Inc. Sec. Litig., 78 F. Supp. 2d 194 (S.D.N.Y. 1999); *In re*Gupta Corp. Sec. Litig., 900 F. Supp. 1217 (N.D. Cal. 1994); *In re*Ross Sys. Sec. Litig., 1994 Fed. Sec. L. Rep. (CCH) ¶ 98,363 (N.D. Cal. 1994).

[71] No. 97C2715, 1998 U.S. Dist. LEXIS 17760 (N.D. Ill. Nov. 4, 1998); *see also In re*JWP Inc. Sec. Litig., 928 F. Supp. 1239 (S.D.N.Y. 1996) (describing the allegations that statements made in company's annual Forms 10-K that were signed by the audit committee precluded a grant of summary judgment).

[72] *First Merchants*, 1998 U.S. Dist. LEXIS 17760.

[73] *Id.* at *6.

[74] *Id.* at *40.

[75] *Id.* at *40–41.

[76] 17 C.F.R. § 210.1-02(g).

cases looked to any ''special role'' played by the audit committee ''in the creation of the allegedly false and misleading statements'' [77] and the ''actual participation'' of the audit committee in the activities which allegedly violated the securities laws.[78] Therefore, if this line of reasoning is followed, the increased responsibilities and authority of the audit committee under Sarbanes-Oxley and related SEC and stock market rules might alone be sufficient to impose control person liability on audit committee members without further evidence of their actual participation in the violation of the securities laws.

D. The Signature Requirement

The Form 10-K report must be signed by a majority of the members of the board of directors and this majority typically includes members of the audit committee. The SEC has stated that ''by signing documents filed with the Commission, board members implicitly indicate that they believe that the filing is accurate and complete.'' [79]

A number of courts have held that a corporate official, acting with scienter, who signs a document that is filed with the SEC that contains material misrepresentations, such as a Form 10-K containing false financial statements, ''makes'' a statement and may be liable as a primary violator under § 10(b) of the 1934 Act for making a false statement. This is true whether or not the director actually participated in the drafting of the document.[80]

E. Sarbanes-Oxley and Related SEC and Stock Market Rules Lead to Increased Liability

Violation of responsibilities imposed on the audit committee by Sarbanes-Oxley would be the basis of liability under the Exchange Act. Section 3(b)(1) of Sarbanes-Oxley provides:

> In General.—A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.[81]

For example, a violation by the audit committee of the pre-approval requirements of § 202 of Sarbanes-Oxley would be a violation of the Exchange Act unless Reg. § 210.2-01(d) were applicable. Although it is unlikely that an occasional inadvertent violation of § 202 would give rise to an SEC civil action, audit committee members should be aware that even technical violations of the Exchange Act may potentially subject them to embarrassing and costly proceedings by the SEC.

Sarbanes-Oxley made two other changes in the law that could affect the individual liability of audit committee members, as well as other directors of ''issuers'' (as defined in § 2(a)(7) of Sarbanes-Oxley).[82] The first change extends the statute of limitations for private lawsuits for damages. Section 804 of Sarbanes-Oxley extended the statute of limitations on private rights of action that involve a claim of fraud, deceit, manipulation, or contrivance in violation of the federal securities laws (defined in § 3(a)(47) of the Exchange Act) to the earlier of two years after discovery of the facts constituting the violation or five years after such violation.[83] Previously, the statute of limitations was one year after discovery of the facts constituting the violation or three years after such violation. The second change made by Sarbanes-Oxley is contained in § 803 which amends § 523(a) of the Bankruptcy Code to eliminate bankruptcy discharge for individuals who violate federal securities laws.[84]

Effective January 31, 2000, the SEC and the major stock markets adopted rules intended to improve disclosures related to the functioning of audit committees and to enhance the reliability and credibility of the financial statements issued by public companies.[85] These rule changes were an attempt to prevent, or at least discourage, corporations from distorting their true financial performance by engaging in abusive ac-

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[77] Haltman v. Aura Sys., Inc., 844 F. Supp. 544, 549 (C.D. Cal. 1993).

[78] Bomarko Inc. v. Hemodynamics Inc., 848 F. Supp. 1335, 1339 (W.D. Mich. 1994) (citing Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1442 (9th Cir. 1987)).

[79] Exchange Act Release No. 34-41,987, 64 Fed. Reg. 55,648, 55,653 (Oct. 14, 1999).

[80] Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 (9th Cir. 2000), (citing *In re*JWP Inc., Sec. Litig., 928 F. Supp. 1239, 1255–56 (S.D.N.Y. 1996) (holding that a director who signs a fraudulent Form 10-K with scienter can be liable as a primary violator for making a false statement under § 10(b)) *and* F.N. Wolf & Co., Inc. v. Estate of Neal, No. 89 CIV.1223 (CSH), 1991 U.S. Dist. LEXIS 2428 (S.D.N.Y. Feb. 25, 1991) (holding that a ''director signing a document filed with the SEC . . . 'makes or causes to be made' the statements contained therein'' under § 1.8(a) of the 1934 Act)); *see also In re*Cabletroff Sys., Inc., 311 F.3d 11, 40 (1st Cir. 2002); *In re*Reliance Sec. Litig., 135 F. Supp. 2d 480, 503 (D. Del. 2001); *In re*Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 767 (S.D.N.Y. 2001), *abrogated on other grounds sub nom. In re*Initial Public Offering Sec. Litig., 241 F. Supp. 2d 281 (S.D.N.Y. 2003); *In re*Lernout & Hauspie Sec. Litig., 286 B.R. 33, 37 (Bankr. D. Mass. 2002) (signatures of three members of the audit committee on statements filed with the SEC ''satisfy the requirement that defendants make a fraudulent statement'' for liability under § 10(b)); *In re*Lernout & Hauspie Sec. Litig., 230 F. Supp. 2d 152, 163 (D. Mass. 2002) (stating that ''[I]t is well established in this Circuit that each defendant may be held responsible for the false and misleading statements contained in the financial statements he signed [under] § 10(b)'') (citing Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 367–68 (1st Cir. 1994)). The Ninth Circuit explained that ''by placing responsibility on corporate officers to ensure the validity of corporate filings, investors are further protected from misleading information.'' *Howard*, 228 F.3d 1057, 1061. Furthermore, ''key corporate officers should not be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements. Otherwise the securities laws would be significantly weakened.'' *Id.* at 1062.

[81] 15 U.S.C. § 7202(b)(1).

[82] See *Audit Committee Provisions of the Sarbanes-Oxley Act of 2002 and Recent Developments,* 49 CPS § II.

[83] 28 U.S.C. § 1658(b).

[84] 11 U.S.C. § 523(a).

[85] See *Response of the SEC to the Blue Ribbon Committee and COSO Reports: 1999 to 2001*, 49 CPS § VIII-E.

counting practices.[86] These abusive accounting procedures are usually an effort to avoid negative investor reaction and the resulting downward slide in stock price associated with the failure to meet earnings expectations.[87] Such practices can lead to investor skepticism, which in turn creates costly, unpredictable market fluctuations.[88] While efforts to improve the quality of financial accounting and reporting by strengthening the audit committee are necessary, the rule changes adopted by the major stock markets and the SEC [89] may have overshot their mark by exposing committee members to increased personal liability. In the face of additional personal liability, it could be argued that it will become increasingly difficult for companies to attract qualified directors to serve on audit committees, thus reducing as opposed to enhancing the effectiveness of audit committees in general. However, this adverse result has not occurred, primarily because audit committee members take comfort in their director and officer liability insurance coverage to guard them against this risk.

With respect to the SEC rule changes effective January 31, 2000, the principal concerns relate to increased liability associated with the audit committee reporting requirements and the inability of the new safe harbor provision (now embodied in Item 407 of Regulation S-K) to adequately protect committee members. Changes adopted by the major stock markets, impacting on the standards for director independence and setting forth suitability requirements for service on audit committees, have also raised the specter of increased liability for both the audit committee and the remaining members of the board of directors who selected them.

1. *The audit committee report*

Item 407(d) of Regulation S-K requires the inclusion of an audit committee report in the company's proxy statement or Form 10-K.[90] Of the four items to be included in the report, three—items (d)(3)(i)(A) through (d)(3)(i)(C)—are procedural in nature and of little consequence to the issue of director liability. The fourth, item (d)(3)(i)(D), however, has been the subject of much controversy and several revisions, due to its potential for increasing the liability of audit committee members. While item (d)(3)(i)(D)'s revisions are not binding, their impact on director liability could be significant because the public policy they were intended to advance was incorporated in the final version of item (a)(4) [91] and subsequently relocated to (d)(3)(i)(D).[92] Thus, the courts, in the context of shareholder or securities litigation, may look to the earlier embodiments of item (d)(3)(i)(D) to ascertain if an audit committee performed its oversight role in a reasonable manner.

As originally proposed by the Blue Ribbon Committee, item (a)(4) required the audit committee to state whether it ''believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.'' [93] This proposal received swift and sound condemnation from many sectors of the business community. Commentators noted that a certification statement along these lines would require a ''level of detailed knowledge of each financial statement line item that even the most expert and diligent committee member could not, and should not be expected to achieve.'' [94] In response to the liability concerns, the SEC proposed a new item (a)(4) requiring the audit committee to state whether ''based on its discussions with management and the auditors, its members became aware of any material misstatements or omissions in the financial statements.'' [95] The inclusion of an affirmative statement concerning the quality of the financial statements was likewise denounced by commentators because of the potential to expose committee members to liability under § 10(b) of the 1934 Act.

The renewed criticism caused the SEC to once again rewrite item (a)(4), requiring audit committees to state ''whether based on the review and discussions referred to in paragraphs (a)(1) through (a)(3), it recommended to the Board of Directors that the financial statements be included in the Annual Report on form 10-K or 10-KSB . . . .'' [96] In proposing and adopting this version of item (a)(4), the SEC sought to provide investors with a better understanding of the audit committee's oversight role in the financial reporting process, while at the same time attempting to alleviate concerns over liability.[97] As was noted above, the requirements in item (a)(4) were relocated to item (d)(3)(i)(D) in an attempt to consolidate corporate governance disclosure requirements.[98]

As adopted, item (d)(3)(i)(D) acknowledges that the audit committee's recommendation is premised on advice and information received through discussions with management and independent auditors.[99] This approach is consistent with state corporation law permitting directors to rely on the ''represen-

[86] *See* SEC v. Del Global Techs. Corp., No. 04CV4092, 2005 SEC LEXIS 2460 (S.D.N.Y. 2005); In the Matter of Ture Roland Fahlin, Admin. Proc. No. 3–11707, 2004 SEC LEXIS 2331.

[87] *See Rotten at the Core*, ECONOMIST, Aug. 17, 1991, at 69–70; *The Judgment of Salomon: An Anticlimax*, BUS. WK., June 1, 1992, at 106; Terence P. Pare, *Nightmare on Wall Street*, FORTUNE, Sept. 5, 1994, at 40–48; Joseph B. Treaser, *Prudential to Pay Policyholders $410 Million*, N.Y. TIMES, Sept. 25, 1996, at D-1.

[88] 17 C.F.R. §§ 210, 228, 229, and 240.

[89] See discussion in *Responses of the Major Stock Markets to the Blue Ribbon Committee and COSO Reports: 1999 to 2001,* 49 CPS § VIII-D, and in *Response of the SEC to the Blue Ribbon Committee and COSO Reports: 1999 to 2001*, 49 CPS § VIII-E.

[90] See *The Audit Committee Report*, 49 CPS § III; *Proxy and information statement disclosure,* 49 CPS § VIII-E1b.

[91] 17 C.F.R. § 229.306, *removed and reserved pursuant to* 71 Fed. Reg. 53,241; *see also* Securities and Exchange Commission, 17 C.F.R. Parts 228, 229 et al., Executive Compensation and Related Person Disclosure; Final Rule and Proposed Rule.

[92] 17 C.F.R. § 229.407(d)(3)(i)(D).

[93] Report & Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), Recommendation 9.

[94] Letter from the Committee on Securities Regulation, Association of the Bar of the City of New York (Nov. 19, 1999).

[95] Exchange Act Release No. 34-41,987 (Oct. 8, 1999), 64 Fed. Reg. 55,648 (proposed Oct. 14, 1999).

[96] Exchange Act Release No. 34-42,266 (Dec. 22, 1999), 64 Fed. Reg. 73,389 (Dec. 30, 1999).

[97] *See id.*

[98] 71 Fed. Reg. 53,158, 53,241 (Sept. 8, 2006).

[99] 17 C.F.R. § 229.306(a)(4) (1999) (current version at 17 C.F.R. § 229.407(d)(3)(i)(D)).

tations of management and the opinions of experts retained by the corporation.'' Through this approach, the SEC contended that director liability would be reduced because, under the appropriate circumstances, a committee's decision to recommend inclusion of the financial statements in the company's proxy would be protected as a valid business judgment.[100] Reduced liability thus insulates audit committee members from liability associated with spurious lawsuits alleging breaches of federal securities laws and state fiduciary duties.

The drafting history of (d)(3)(i)(D) (formerly (a)(4)) clearly demonstrates both the SEC's and the major stock markets' desire to foster financially savvy, inquisitive, and proactive audit committees. Called on to judge the reasonableness of a committee's conduct, a court may very well look past the verbiage of item (d)(3)(i)(D) as enacted, choosing instead to hold the audit committee liable for failing to adhere to the standards embodied in the early versions of (d)(3)(i)(D). Whether item (d)(3)(i)(D) leads to increased or decreased liability for committee members will not be known until this provision is tested through litigation.

Implicit in the audit committee report statement that they ''recommend'' the inclusion of the financial statements in the Form 10-K report is the fact that the audit committee actually believes the financial statements conformed to GAAP. Also implicit in this statement is that the audit committee had a reasonable basis for the belief. Therefore, it is not clear that the language change from the Blue Ribbon Report wording to the final SEC rule was really that meaningful.

While the liability facing directors may emanate from many sources, their primary exposure for the audit committee report can be attributed to actions alleging breaches of their state and common law fiduciary duties of care, loyalty, and candor (in the case of Delaware corporations) and § 10(b) of the Exchange Act and comparable provisions of state securities laws.

As discussed in 49 CPS § VII-A, in accordance with the duty of care, directors are expected to remain fully informed of all issues relating to the performance of their duties.[101] This duty would include an obligation to be aware of SEC and stock market rules and to abide by those rules when to do otherwise would negatively impact the company.

Although a breach of the duty of care claim is the most obvious basis for a claim, directors may also, in certain circumstances, be susceptible to liability based on a breach of their duty of loyalty and their duty of candor. Should a nexus exist between a violation of an SEC or a stock market rule and a director receiving a benefit not bestowed upon the company generally, the director may face liability from a cause of action premised on a breach of the duty of loyalty. Likewise, disclosures in the proxy or information statement mandated by the SEC rules, adopted effective January 31, 2000, could give rise to a claim of the breach of the duty of candor owed to shareholders (in the case of a Delaware corporation). The director could be viewed as breaching the duty of candor if the audit committee report failed to note serious reservations which existed concerning the financial statements which they ''recommend'' for inclusion in the Form 10-K report.

If the members of the audit committee recklessly recommended the inclusion of financial statements in the Form 10-K report, and the audit committee report is relied upon by investors to their detriment or is presumed to be relied upon (as a result of a fraud on the market theory), a Rule 10b-5 action could be brought under § 10(b) of the Exchange Act (or comparable provisions of state securities laws) against the audit committee members as participants or co-conspirators with the company in the Rule 10b-5 violation.

2. *Audit committee charter*

The SEC rules, effective January 31, 2000, also required that any written charter of the audit committee be included as an appendix to the company's proxy statement, unless a copy has been included as an appendix to the proxy statement within the company's past three fiscal years.[102] Currently, Instruction 2 to Item 407 of Regulation S-K requires companies to disclose whether a current copy of the audit committee charter is available to security holders on the company's website and, if so, to provide the company's website address. If a current copy of the charter is not available to security holders on the company's website, the company must include a copy of the charter in an appendix to the company's proxy statement that is provided to security holders at least once every three fiscal years, or if the charter has been materially amended since the beginning of the company's last fiscal year. If a current copy of the charter is not available to security holders on the company website and is not included as an appendix to the company's proxy or information statement, the company must identify in which of the prior fiscal years the charter was so included in satisfaction of this requirement.[103]

The charter may be viewed as a representation by the audit committee of the functions which would be performed by the audit committee. The failure to perform these functions, advertised to shareholders in the proxy statement, could itself be viewed as a basis for personal liability of audit committee members, if the failure to perform those functions resulted in financial loss to the shareholders.

Accordingly, it is not recommended that the charter be used as a checklist of ''best practices'' to be performed by the audit committee. It is preferable to limit the duties contained in the audit committee charter to those which must be performed by law or by applicable listing standards.

3. *Safe harbor provision*

When enacting the audit committee disclosure requirements effective January 31, 2000, the SEC stated that it did not ''intend to subject companies or their directors to increased exposure to liability under the federal securities laws, or to create new standards for directors to fulfill their duties under state corporation law.'' [104] Despite these assurances, there was widespread concern by commentators that the SEC rules, adopted effective January 31, 2000, would subject audit committee members to increased liability under § 10(b) of the Ex-

[100] Exchange Act Release No. 34-42,266 (Dec. 22, 1999), 64 Fed. Reg. 73,389 (Dec. 30, 1999).

[101] See *State Law Fiduciary Duties,* 49 CPS § VII-A.

[102] See *Response of the SEC to the Blue Ribbon Committee and COSO Reports: 1999 to 2001,* 49 CPS § VIII-E.

[103] 17 C.F.R. § 229.407 at Instruction 2.

[104] *Id.*

change Act [105] or state securities and state corporate law claims.[106] The SEC attempted to address these concerns by adopting safe harbors that track the treatment of compensation committee reports under Item 402 of Regulation S-K and consider the additional disclosure not to be ''soliciting material'' ''filed'' with the SEC, subject to Regulation 14A or 14C or to the liabilities of § 18 of the Exchange Act. While a step in the right direction, the safe harbors are still widely viewed as inadequate to provide audit committee members with protection from their increased legal exposure.[107]

Of particular concern is the safe harbor's failure to shield audit committee members by: (i) not preempting state corporation laws providing for actions for breaches of the fiduciary duties of care or loyalty or the duty of candor (in the case of Delaware corporations) in disclosures, (ii) not preempting state securities laws,[108] and (iii) failing to address the unsettled state of the law as to what degree of reckless conduct is sufficient to support a finding of scienter in actions brought under § 10(b) of the Exchange Act and Rule 10b-5 thereunder and how recklessness is to be pleaded and proved.[109] In support of the limited safe harbor, and in the face of the above criticism, the SEC has stated that ''the more informed the audit committee becomes through its discussions with management and the auditors, the more likely that the business judgment rule will apply and provide broad protection.'' [110]

This view, however, is flawed to the extent the business judgment rule does not cover violations of the duty of care, the duty of loyalty, the duty of candor (in the case of Delaware corporations), or liability under § 10(b), with respect to disclosures by audit committees to stockholders or the public.[111] As adopted, item (d)(3) requires the committee to state in the annual proxy whether or not it discussed the company's financial statements with the outside auditors and management. This requirement appears benign at first glance, but committee members will be exposed to significant liability if accounting irregularities surface after release of the proxy statement. For example, should the committee indicate it held discussions with the outside auditors and management, the committee members may be accused of recklessly failing to uncover the inaccuracies, breaching their duty of care, or recklessly disseminating false information to the shareholders, breaching their duty of candor, and/or violating § 10b-5.[112] Conversely, should the committee not hold the discussions contemplated by items (a)(1) through (a)(3), it may be alleged that their ''willful blindness'' or ''deliberate ignorance'' breached their fiduciary duties and violated § 10b-5.[113]

Section 32(a) of the Exchange Act imposes criminal sanctions on ''any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title.'' Upon conviction, a natural person can be fined up to $2.5 million or imprisoned for up to 10 years, or both.

Under the ''safe harbor,'' the audit committee report and related proxy statement information is not considered ''filed'' with the SEC. However, criminal liability under § 32(a) of the Exchange Act can still be based upon the Form 10-K reports which are filed with the SEC under the Exchange Act, if the audit committee member was considered an aider and abettor, co-conspirator, or participant in the filing of false financial statements included (or incorporated by reference) in the Form 10-K. This is especially true if the audit committee member signed the Form 10-K.

Criminal liability of audit committee members could also be based on violations of the mail fraud statute (18 U.S.C. § 1341) and wire fraud statute (18 U.S.C. § 1343), among other federal and state statutes.

4. *Independence requirements*

In 1999, in response to the Blue Ribbon Committee's recommendations, the major stock markets sought and received SEC approval to amend their rules governing audit committee standards. The purpose for the rule changes was ''to strengthen the independence and effectiveness of corporate audit committees, outside directors and management.'' [114]

With respect to audit committee composition, the 1999 rules require audit committees to have a minimum of three members and be comprised of independent directors only (subject to certain exceptions, such as small business filers on

[105] *See* Comments of Stephen J. Shulte, Chair, Committee on Securities Regulation, Association of the Bar of the City of New York (Dec. 10, 1999).

[106] *See* Comments of Kathryn E. Surface, Co-Chair, Government Relations Committee, National Association of Real Estate Investment Trusts (Dec. 14, 1999).

[107] *See* Comments on Proposed Rule: Audit Committee Disclosure, Securities and Exchange Commission File No. S7-22-99.

[108] Section 28(f)(4) of the Exchange Act preserves the authority of state securities agencies to bring actions under state Blue Sky laws. 15 U.S.C. § 78bb(f)(4).

[109] *See* Comments of Stanley Keller, Chair, Committee on Federal Regulations of Securities, and Richard H. Rowe, Chair, Committee on Law and Accounting, American Bar Association (Dec. 3, 1999).

[110] Exchange Act Release No. 34-42,266 (Dec. 22, 1999), 64 Fed. Reg. 73,389 (Dec. 30, 1999).

[111] There is currently a split in the federal appellate courts on the issue of whether reckless conduct will support a finding of scienter and, if so, what conduct constitutes recklessness and how claims of recklessness should be plead for purposes of 10b-5 actions. *See In re*IKON Office Solutions, Inc. Sec. Litig., 66 F. Supp. 2d 622 (E.D. Pa. 1999).

[112] *Id.*

[113] By establishing willful blindness or deliberate ignorance, a plaintiff may avoid the need to plead scienter or recklessness on the part of a director in an action alleging a 10b-5 violation or breach of fiduciary duty. As held by the First Circuit, directors cannot avoid liability by purposefully shutting their eyes to means of information within their possession and control. Torpey v. Interstate Equip. Leasing Corp., 760 F.2d 364, 365 (1st Cir. 1985); *see also* Lemanski v. Lenox Sav. Bank, No. CIV. A. 95-30074-MAP, 1996 WL 253315 (D. Mass. Apr. 12, 1996). This is especially true when the directors should have known ''something was afoot.'' *Id.*

[114] *See* Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc., Exchange Act Release No. 34-42,231 (Dec. 14, 1999), 64 Fed. Reg. 71,523 (Dec. 21, 1999); Order Approving Proposed Rule Change by the American Stock Exchange, Inc., Exchange Act Release No. 34-42,232 (Dec. 14, 1999), 64 Fed. Reg. 71,518 (Dec. 21, 1999); Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. [hereinafter NYSE Rule Change], Exchange Act Release No. 34-42,233 (Dec. 14, 1999), 64 Fed. Reg. 71,529 (Dec. 21, 1999).

NASDAQ or NYSE MKT).[115] The 1999 rules also proscribe a minimum level of financial proficiency. Specifically, ''all directors must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement.'' [116] In addition, ''at least one director must have past employment experience in finance or accounting, requisite professional certification in accounting,'' or other comparable experience, ''including a current or past position as a chief executive or financial officer or other senior officer with financial oversight responsibilities.'' [117]

As a result of § 301 of Sarbanes-Oxley, the national securities exchanges and the national securities association further strengthened these independence rules. In response to § 301, the SEC adopted, effective April 25, 2003, Rule 10A-3 and further amendments to the disclosure requirements in proxy and information statements with respect to the independence of audit committee members.[118]

Whether or not there is an implied right of action for violation of stock market rules,[119] the SEC rules require disclosure in proxy and information statements as to whether the audit committee satisfied the independence test established by major stock markets. Reckless misstatements on this issue in proxy or information statements can give rise to an implied right of action under Rule 10b-5.

By requiring the board of directors to examine the background and financial literacy of potential audit committee members, the SEC rules, adopted effective January 31, 2000, may have created a procedure that increases the exposure to liability of both audit committee members and those who nominate committee members. It has traditionally been the province of the board of directors to ensure that the collective background and experience of committee members provides sufficient knowledge of financial accounting and reporting to meet their responsibilities. However, as a result of the SEC rules, adopted effective January 31, 2000, audit committee members may face liability based on allegations they lacked the requisite financial literacy for their positions on the committee, while the larger board could face liability for negligent assessment of a committee member's qualifications.

When the board of directors establishes an audit committee for a company whose shares are listed on the NYSE, NASDAQ, or NYSE MKT, consideration should be given to reciting in the resolution adopted by the board of directors the reason why the board has determined that the appointees satisfy the independence and financial literacy tests of the NYSE, NASDAQ, or NYSE MKT, as applicable.

The heightened requirements for service on an audit committee may lead to the increased applications of the differential standard of liability.[120] This is of particular concern to those with accounting or financial expertise, such as CPAs or former chief financial officers, because such members are at greater risk of being held to a standard higher than that applied to the general board and less knowledgeable audit committee members. The establishment of different classes of directors with increased exposure, real or perceived, may discourage qualified directors from serving on the audit committee, leading to less effective audit committees.

F. SEC Enforcement Actions Against Audit Committee Members

The SEC's enforcement actions against audit committee members have been very sporadic. The following are a few examples.

Audit Committee of Swisher International, Inc. In 2001, the SEC initiated cease-and-desist proceedings against George Kelly Moore, a director, audit committee member, and paid consultant of Swisher International, Inc. Mr. Moore, who provided advice to the company's accounting department, allegedly directed the accounting staff to prematurely record the sale of one of the company's franchises. Mr. Moore also failed to disclose that Swisher's CEO was the true purchaser of the franchise. Mr. Moore was accused of violating or causing violation of §§ 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the 1934 Act (together with associated rules) and § 17(a)(2) of the 1933 Act.[121]

Audit Committee of Chancellor Corporation. In 2003, the SEC sued an outside director of Chancellor Corporation, Rudolph Peselman, for financial fraud.[122] Peselman, who served on Chancellor's audit committee, had allegedly failed to take steps to determine whether management's position on the accounting for a transaction was correct, despite there being a disagreement between management and the company's auditors, and had allowed Chancellor to replace the auditors over the disagreement.[123] According to then-SEC Enforcement Director Stephen Cutler, Peselman was ''reckless in [his] oversight of management and asleep at the switch.'' Cutler called the case the ''first salvo'' against board members who ignore misconduct and said the Commission would use the Peselman case as a model.[124]

Audit Committee of Heartland Group, Inc. In 2003, the SEC initiated cease-and-desist proceedings against four inde-

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[115] Under certain circumstances, however, these 1999 rules do permit non-independent directors to serve on an audit committee provided that the board determines it to be in the interest of the corporation and the board discloses the reasons for the determination. *See, e.g.*, NYSE Rule Change, *supra* note 114.

[116] See *Audit committee responsibility and authority*, 49 CPS § II-E7.

[117] See *Audit Committee Provisions of the Sarbanes-Oxley Act of 2002 and Recent Developments*, 49 CPS § II.

[118] *Id.*

[119] As a general principle, a violation of the stock market rules does not create a private cause of action against the company or its directors. *In re*Verifone Sec. Litig., 11 F.3d 865, 870–71 (9th Cir. 1993); Jablon v. Dean Witter & Co., 614 F.2d 677, 680–81 (9th Cir. 1980). *But see* Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir. 1975); State Teachers Ret. Bd. v. Flour Corp., 654 F.2d 843 (2d Cir. 1981).

[120] See discussion in *Differential Liability*, 49 CPS § VII-B. Although the application of differential liability is not certain, the rule changes do, at a minimum, create two classes of directors—those who are qualified to serve on an audit committee and those who are not. *See* Comments of Jack Edwards, Audit Committee of Northrop Grumman Corporation Board of Directors (Nov. 30, 1999).

[121] In the Matter of George Kelly Moore, Admin. Proceeding No. 3-10570, Exchange Act Release No. 34-44,781 (Sept. 10, 2011).

[122] Christopher Cox, Chairman, SEC, Remarks at Corporate Directors Forum (Jan. 31, 2006).

[123] SEC v. Chancellor Corp., No. 03-10762 MEL (D. Mass. filed Apr. 24, 2003); SEC Litigation Release No. 18104 (Apr. 24, 2003).

[124] Bloomberg, *SEC to Target ''Reckless'' Directors in Fraud*

pendent directors and audit committee members of Heartland Group, Inc., an investment management company that offered a series of mutual funds. The directors allegedly failed to assure that bonds held in Heartland's funds were priced at ''fair value'' and had adequate liquidity. The directors were accused of violating §§ 17(a)(2) & (3) of the Securities Act and causing Heartland to violate portions of the Investment Company Act of 1940. (The allegations did not specifically implicate the directors' roles as audit committee members.) The directors consented to the entry of cease-and-desist orders against them.[125]

Audit Committee of Del Global Technologies Corp. In 2004, the SEC initiated two actions against audit committee members for failure to fulfill their audit committee duties. In *SEC v. Del Global Technologies Corp.*, the SEC charged David Michael (a former Del director and former chairman of Del's audit committee), among others, with participating in a multi-year accounting fraud at Del that resulted in a material overstatement of revenues.[126] According to the complaint, Del routinely engaged in improper revenue recognition when it held open quarters, prematurely shipped products to third-party warehouses, and recorded sales on products that Del had not yet manufactured. The complaint also alleged that Del improperly accounted for inventory by recording obsolete inventory at full value and overstating certain engineering work in process values. In addition, the complaint alleged that Del improperly characterized certain ordinary expenses as capital expenditures. Michael settled with the SEC in September 2005, agreeing to pay a $20,000 penalty. He was also permanently barred from serving as an officer or director of a public company.

Audit Committee of Koninklijke Ahold N.V. *In the Matter of Ture Roland Fahlin*, the SEC initiated, in October 2004, cease-and-desist proceedings against Ture Roland Fahlin, a member of the audit committee of the supervisory board of Koninklijke Ahold N.V.[127] Fahlin was accused of failing to fulfill his duties as an audit committee member in connection with an improper consolidation of one of Ahold's joint ventures in Ahold's financial statements. Fahlin allegedly approved of Ahold's financial statements consolidating the joint venture's financial information, despite knowing that the auditors were relying upon a control letter that had later been rescinded. Subsequently, Ahold discovered that the consolidated financial statements were improper and was forced to issue restated financial statements. Fahlin consented to the entry of a cease-and-desist order against him.

The SEC characterized Fahlin's conduct as follows:

> Prior to approving Ahold's annual report and financial statements for 2001, Fahlin reviewed the Auditors' report, which disclosed that the Auditors were relying on an ICA 'control letter' in allowing the full consolidation of ICA Ahold's financial results. The audit committee plays an essential role in assuring that a company's financial statements have been presented fairly and in conformity with GAAP. Members of the audit committee must take this responsibility seriously. As a member of Ahold's supervisory board and audit committee, Fahlin had a duty to determine whether the 'control letter' referenced in the Auditors' report was related to the letter he had initially signed and then rescinded in May 2000 and, if so, he should have informed the Auditors and the other members of the supervisory board of the existence of the ICA rescinding letter prior to approving Ahold's annual report and financial statements for 2001. Fahlin failed to fulfill these duties.[128]

Audit Committee of Spiegel, Inc. In 2006, the SEC charged two outside directors of Spiegel, Inc. in connection with the decision to withhold required financial reports to avoid issuance of a ''going concern'' opinion by the company's auditors.[129]

Audit Committee Chair of InfoUSA Inc. On March 15, 2010, the SEC filed civil injunctive actions charging former senior executives and a former director of InfoUSA Inc., k/n/a InfoGROUP, Inc. (''Info'') with securities fraud and other violations of the federal securities laws.[130] Specifically, the Commission's complaints against Vinod Gupta, Info's former CEO and Chairman, Vasant H. Raval, former chairman of Info's audit committee, and Rajnish K. Das and Stormy L. Dean, Info's CFOs during the relevant period, allege that from 2003 through 2007, the defendants caused Info to pay Gupta almost $9.5 million of unauthorized and undisclosed perquisites and to enter into $9.3 million of undisclosed related party transactions with Gupta's entities.

The SEC also alleged that from January 2005 through July 2006, Raval, Info's former audit committee chairman, failed to respond appropriately to various red flags concerning Gupta's expenses and Info's related party transactions with Gupta's entities. According to the complaint, Raval failed to take appropriate action regarding the concerns expressed to him by two Info internal auditors that Gupta was submitting requests for reimbursement of personal expenses. Additionally, the complaint alleged that, notwithstanding his charge by Info's board in January 2005 to investigate potential improper payments to Gupta, Raval failed to take meaningful action to further investigate Gupta's misconduct and omitted critical facts in his report to the board concerning Gupta's expenses.

Audit Committee of DHB Industries, Inc. On February 28, 2011, the SEC filed fraud charges against Jerome Krantz, Cary Chasin, and Gary Nadelman, three former outside directors and audit and compensation committee members of DHB Industries, Inc. (DHB or the Company), a supplier of body armor to the military and law enforcement.[131] The SEC sought fraud injunctions, disgorgement of ill-gotten gains, monetary

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Cases, Cutler Says (Aug. 20, 2003).

[125] Jonathan C. Dickey & Daniel P. Muino, *Audit Committee Liability: Recent Actions Against Audit Committee Members*, PLI Audit Committee Workshop 2006 (July 19, 2006).

[126] No. 04CV4092, 2005 SEC LEXIS 2460 (S.D.N.Y. 2005).

[127] Admin Proc. No. 3-11707, Exchange Act Release No. 34-50,519 (Oct. 13, 2004).

[128] *Id.* at *7–8.

[129] SEC v. Crusemann and Otto, No. 06-CV-5969 (N.D. Ill. filed Nov. 2, 2006); *In re* Horst Hansen, SEC Exchange Act Release No. 34-54,689 (Nov. 2, 2006); SEC Litigation Release No. 19897 (Nov. 2, 2006).

[130] SEC v. Raval, No. 8: 10-cv-00101 (D. Neb. filed Mar. 15, 2010); SEC Litigation Release No. 21451 (Mar. 15, 2010).

[131] SEC v. Krantz, Chasin, and Nadelman, No. 0:11-cv-60432-WPD (S.D. Fla. filed Feb. 28, 2011); SEC Litigation Release No. 21,867 (Feb. 28, 2011).

penalties, and officer and director bars against Krantz, Chasin, and Nadelman. At the same time that the SEC filed the litigated action against the three former directors, the SEC filed a settled enforcement action against DHB.[132] The SEC alleged that DHB, through its senior executive officers, engaged in accounting and disclosure fraud and misappropriation of assets that resulted in the Company filing materially false and misleading periodic reports with the SEC. Ultimately, the Company was compelled to file for bankruptcy.

From at least 2003 through 2005, senior management at DHB allegedly engaged in widespread accounting fraud, disclosure fraud, and misappropriation of Company assets. DHB lacked adequate internal accounting and financial reporting controls. As a result, senior management was allegedly able to manipulate DHB's gross profit margins and earnings by overstating inventory values, falsifying journal entries, and failing to include appropriate charges for obsolete inventory. DHB's lack of internal controls also enabled the Chief Executive Officer, David Brooks (a recidivist securities law violator) to funnel at least $10 million out of DHB through fraudulent transactions with a related entity he controlled. Brooks and others also allegedly misappropriated millions from the Company through the use of Company funds to pay for personal expenses, including luxury cars, jewelry, extravagant vacations, prostitutes, and Brooks' horse racing empire. In 2007, DHB restated its financial results for 2003, 2004, and 2005, which eliminated all of DHB's previously reported 2003 and 2004 profits.

An alleged reason that Brooks and the other two senior managers were able to carry out their scheme for three years was a failure by DHB's three non-management directors "to carry out their responsibilities as 'independent' directors and Audit and Compensation . . . Committee members" because they "were willfully blind to numerous red flags signaling accounting fraud, reporting violations and misappropriation at DHB. Instead, as the fraud swirled around them, they ignored the obvious and merely rubber-stamped the decisions of DHB's senior management while making substantial sums from sales of DHB's securities."

The SEC's complaint against Krantz, Chasin, and Nadelman describes a number of red flags that should have placed the outside directors on notice of the misconduct. For example, DHB's then-auditors issued a material weakness letter to the Audit Committee concerning DHB's internal controls over financial reporting, particularly with respect to inventory. After that audit firm resigned,[133] DHB's new auditors also identified multiple internal control deficiencies. The directors also learned that DHB's then-controller had concerns over the Company's inventory valuation and had resigned. Despite these concerns raised by the Company's auditors and controller, Krantz, Chasin, and Nadelman allegedly failed to take any meaningful actions. Further, the directors were allegedly aware of specific allegations about DHB's undisclosed related-entity transactions through a company that Brooks controlled. Instead of conducting an independent investigation, the SEC alleged that Krantz, Chasin, and Nadelman "allowed Brooks to commission and control an investigation into the issue, which essentially allowed senior management to investigate itself." The law firm that Brooks hired ultimately resigned and called into question its report of the investigation based on previously undisclosed information. Brooks thereafter hired a second law firm and a consulting firm to investigate the issue, again controlling the investigation. Brooks subsequently fired the consulting firm when it questioned his personal expenses. The directors also became aware that the SEC had subpoenaed DHB for documents and requested information regarding the company that Brooks controlled. Despite the resignations of the auditors and law firm, Brooks' termination of the consulting firm, and several SEC subpoenas and request letters, Krantz, Chasin, and Nadelman allegedly "continued to ignore these numerous red flags" and failed to take reasonable steps to address them.

The SEC's complaint further alleged that Krantz, Chasin, and Nadelman "willfully ignored red flags because of their loyalty to Brooks and their own self-interest" and "lacked impartiality to serve as independent Board or Audit Committee members." The three outside directors were longtime friends and neighbors of Brooks and had personal relationships with Brooks that spanned decades. Further, they each had business relationships with Brooks that allegedly influenced their impartiality and independence. Krantz served as the insurance agent for DHB and Brooks' family while also serving as a board member. Chasin and his family went out to dinner with Brooks and his family two or three times a month. Chasin also worked for DHB for a few months on two occasions prior to joining DHB's board, and each time Chasin was paid approximately $100,000. Nadelman and his family regularly attended Brooks family social functions, and he was a significant investor in one of Brooks' private companies. The complaint further alleged that the outside directors were influenced by Brooks' wealth and the perks that he provided to them, including stock warrants and seats to DHB's skybox at Madison Square Garden, which Brooks told the directors they could use to help their outside businesses.

Audit Committee Members of Investment Funds. The SEC enforcement division on December 10, 2012 filed public administrative and cease and desist proceedings against the following independent directors of the audit committee of five registered investment funds: Jack R. Blair, Albert C. Johnson, James Stillman R. McFadden, W. Randall Pittman, Mary S. Stone, and Archie W. Willis III.[134] All of the accused audit committee members were designated as "audit committee financial experts." The complaint alleges that the investment funds contained below investment grade debt securities, some of which were backed by sub-prime mortgages, for which market quotations were not readily available, even though the Investment Company Act required these securities to be valued at fair value as determined in good faith by the directors.

Although the directors were entitled to appoint persons to assist them in determining fair value, it was the board's responsibility, according to the complaint, to continuously review the

[132] SEC v. DHB Inds., Inc., No. 0:11-cv-60431-JIC (S.D. Fla. filed Feb. 28, 2011); SEC Litigation Release No. 21,867.

[133] The auditors who replaced this audit firm ultimately resigned as well, following DHB's filing of its 2004 annual report with the SEC without the auditors' permission.

[134] In the Matter of J. Kenneth Alderman et al., Admin. Proceeding No. 3-15,127, Investment Company Act Release No. 30,300 (Dec. 10, 2012).

appropriateness of the method used in valuing each security. According to the complaint, the board delegated this duty to employees of Morgan Keegan & Co., the investment advisor, and failed to either specify a fair valuation methodology or review the appropriateness of the method being used. In addition, the independent directors made no meaningful effort to learn how fair values were actually being determined. The result was that, according to the complaint, the net asset value of the funds was materially misstated.

Audit Committee of AgFeed Industries, Inc. On March 11, 2014, the SEC filed an enforcement action in the Middle District of Tennessee against AgFeed Industries, Inc. (''AgFeed'') and certain of its current and former directors and officers including K. Ivan Gothner, who served as chair of the company's audit committee, and Edward Pazdro, who served for a time as the company's CFO.[134A] The SEC's complaint alleged that from 2008 through June 30, 2011, AgFeed, an animal nutrition and hog production company, overstated its revenue by $239 million. The fraud allegedly was orchestrated by the company's Chinese management. The complaint alleges that in May 2011, Gothner and Pazdro learned that the hog production division had maintained two sets of books in Chin—a real set and a fake set. In June 2011, Gothner and Pazdro received a report from Chinese counsel at AgFeed which concluded based on witness statements and documents that AgFeed had maintained the two sets of books for the purpose of inflating revenue and profits, that the company's former CEO and CEO had directed the fraud, and that the former CFO had ordered the destruction of the second set of books.

The complaint alleges that between June 2011 and September 2011, a period during which the company was engaged in an effort to raise capital to transform the company into a ''modern, international hog producer,'' Gothner and Pazdro ''engaged in a scheme to avoid or to delay disclosure of the fraud,'' including failing to disclose the fraud to auditors and to key company personnel. With respect to Gothner, the audit committee chair, the SEC further alleges that he misrepresented to counsel that a third-party expert had been hired to analyze the USB stick on which the two sets of books were maintained when no expert had in fact been hired. Both Gothner and Pazdro are alleged to have failed to ''conduct further meaningful inquiries into the fraud even as additional red flags arose.'' The complaint further alleged that their failure to act on the fraud allowed the company to file a false and misleading Form 10-Q in August 2011 and that both Gothner and Pazdro ''had strong financial incentives'' and ''stood to receive increased compensation'' if the transformation of the company succeeded.

Audit Committee of L&L Energy. On March 27, 2014, the SEC filed an administrative cease and desist order against Shirley Kiang, the former audit committee chair of L&L Energy, a Seattle-headquartered coal company with all of its operations in China.[134B] The order alleged that the company misrepresented in public filings that a person was serving as the company's acting chief financial officer when in fact that person never did. The order alleges that in May 2009 while Kiang was audit committee chair, the purported acting chief financial officer became aware that she had been falsely represented as the company's acting CFO, and that the purported acting CFO asked Kiang to investigate. Kiang advised the company's chairman of the information; the chairman told Kiang that the person had never actually served as the a cting CFO and that Kiang should not share this information with anyone, including the company's board of directors or the public.

In August 2009, the company filed its Form 10-K for the 2009 fiscal year, and it included, according to the order, a false certification required under Sarbanes-Oxley that – based upon the certifying officers' most recent evaluation of the company's internal control over financial reporting – any fraud, whether or not material, involving management had been disclosed to the company's auditors and the company's audit committee. Kiang signed this public filing as a director and audit committee chair when she knew or should have known that the filing contained this false Sarbanes-Oxley certification.

The SEC's cease and desist order charges that by withholding the information that the purported acting CFO had not served as the actual acting CFO and allowing the false certifications to be filed, Kiang ''caused'' the company to violate the reporting requirements of the securities laws. Kiang agreed to settle with the SEC without admitting or denying allegations and consented to the entry of an order directing her to cease and desist from any future violations.

G. Insulating Directors From Potential Liability as Audit Committee Members

The emergence of the doctrine of differential liability increases the potential liability of audit committee members.[135] Consequently, it is necessary for the committee to adopt measures that will reduce the risks associated with its responsibilities. Three proposals are commonly offered: indemnification, liability insurance, and the institution of procedures intended to constitute a record of committee activity. It is advisable that each be considered, and, perhaps, that all three be adopted.

As noted at the beginning of this chapter, audit committees should also consider whether or not to retain their own special counsel who would assist members in performing their duties.

1. *Indemnification*

There is a significant trend in the states toward statutorily authorizing some type of indemnification of corporate directors and officers.[136] Virtually all states have enacted legislation that gives the directors the right to indemnification for defending

[134A] Press Release, SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud (March 11, 2014).

[134B] Press Release, U.S. Securities and Exchange Commission, SEC Announces Fraud Charges Against Coal Company and CEO for False Disclosures About Management (March 27, 2014).

[135] One analysis of the developments in the field of director liability stated that ''it appears that under state law and the federal securities laws the duties of Audit Committee membership are inescapably accompanied by an attendant increase in potential liability.'' Edward F. Greene & Bernard B. Falk, *The Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of Its Objectives and Functions*, 34 BUS. LAW. 1229, 1248 (1979).

[136] The genesis of this trend can be traced to New York Dry Dock Co. v. McCollom, 16 N.Y.S.2d 844 (N.Y. Sup. Ct. 1939), which held

actions arising out of their corporate conduct whether they are successful on the merits or not.[137] Such statutes usually differentiate between derivative lawsuits, i.e., direct lawsuits for the benefit of the corporation, and third-party actions in which parties claim damage to themselves. Also, they tend to authorize indemnification if the statutory standards are met,[138] whether the action is terminated by judgment, settlement, conviction, or plea of nolo contendere.

While audit committee members might find some solace in the right to indemnification, they should be aware that it does not afford them complete protection under all circumstances. For instance, some courts have held that indemnification against violations of the federal securities laws is against public policy.[139] The SEC also has adopted this position and, in fact, has promulgated a rule to that effect in regard to the acceleration of the effective date of a securities offering.[140]

2. *Elimination of duty of due care*

A number of state business corporation laws permit the charter or bylaws to contain a provision approved by shareholders eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages. Section 102(b)(7) of the Delaware General Corporation Law is typical of these provisions. It permits the certificate of incorporation to include:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under Section 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.[141]

This provision does not protect directors from personal liability for a violation of federal law, such as the federal securities or antitrust laws, or from the consequences of the violation of the laws of states other than Delaware, or even Delaware law apart from the law of a director's fiduciary duty. This provision does not permit the elimination of the duty of loyalty or the duty of candor, but does permit elimination of personal liability of a director for monetary damages for breach of the Delaware duty of care.

3. *Good faith reliance*

A number of states permit directors to be protected by relying in good faith on the records of the corporation and on information, opinions, reports, and statements from officers or employees of the corporation, as well as third party experts. Section 141(e) of the Delaware General Corporation Law is typical of these provisions. Section 141(e) provides as follows:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[142]

4. *Liability insurance for directors and officers*

All members of the board and particularly the members of the audit committee must have director and officer (''D&O'') liability insurance, coverage for themselves personally that is not disclaimable by the insurance company for misstatements in the policy of which the director was not aware.[143] At least four risks should be of particular concern.

- Is there sufficient coverage?
- Is there coverage if the company is in bankruptcy?
- Is there coverage if the financial statements of the company submitted with the insurance application were false and misleading? [144]
- Is the insurer that issues the policy financially able to honor the policy?

A D&O insurance policy typically consists of three parts:

- Side A coverage for directors and officers personally;
- Side B coverage for the corporation to the extent the organization is required to indemnify directors and officers under its bylaws;
- Side C coverage for the organization's own liability.

Audit committee members should insist on Side A coverage (sometimes called ''Side A-only excess coverage''), with

in a derivative action that directors could not be indemnified under common law despite the fact that they were successful in defending themselves; they had conferred no benefit on the corporation, the court said.

[137] *See, e.g.*, DEL. CODE. ANN. tit. 8, § 145; N.Y. BUS. CORP. LAW §§ 721–26; 15 PA. CONSOL. STAT. ANN. §§ 1741–50.

[138] The standard, as articulated by the Delaware Code, DEL. CODE. ANN. tit. 8, § 145, is met if the insured party acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

[139] *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969); Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975).

[140] 17 C.F.R. § 230.461 (2003).

[141] DEL. CODE ANN. tit. 8, § 102(b)(7).

[142] DEL. CODE ANN. tit. 8, § 141(e).

[143] See Paul F. Matousek et al., *Indemnification and Insurance for Directors and Officers*, 54 CPS.

[144] *See* Fed. Ins. Co. v. Homestore, Inc., 144 Fed. Appx. 641 (9th Cir. 2005); Cutter & Buck Inc. v. Genesis Ins. Co., 144 Fed. Appx. 600 (9th Cir. 2005); TIG Ins. Co. of Mich. v. Homestore, Inc., 40 Cal. Rptr. 3d 528 (Cal Ct. App. 2006).

coverage limits that are not tied to the limits of Side B or Side C. If a bankruptcy petition is filed with respect to the corporation, and there is no Side A coverage, a question arises as to whether the audit committee members may still draw down on the policy to fund legal defense costs or to pay claims. Several bankruptcy courts have raised the issue that director drawdowns on a D&O policy may be depleting an asset of the bankrupt estate of the corporation and, therefore, the bankruptcy court could enjoin the director drawdowns. Even the existence of a single combined coverage limit for both Side A and Side B (corporate reimbursement coverage) may result in delays in obtaining coverage for legal fees and expenses incurred by the director until bankruptcy court approval is obtained.

There is also a more comprehensive version of Side A-only excess coverage known as Side A-only Difference-in-Conditions (''DIC'') excess coverage. Under DIC coverage, the excess policy will ''drop down'' to provide coverage when another insurer fails to pay a claim (including as a result of insurer insolvency) or when a company fails to indemnify. In order to provide the greater protection against insurer insolvency, companies that purchase DIC excess coverage should consider purchasing it from an insurer that is not on the underlying Side A, Side B, or Side C insurance policy.

Some typical exclusions from coverage are claims for:

- fraud, dishonesty, and criminal conduct;
- short-swing profits recoverable under § 16 of the 1934 Act;
- libel and slander;
- failure to effect and maintain insurance bonds;
- bodily injury or tangible property damage;
- gains, in fact, of unentitled personal profit or advantage;
- the return of remuneration to an insured if not approved by shareholders and held to be illegal by the courts;
- insured versus insured claims;
- claims by regulatory authorities; and
- Employment Retirement Income Security Act claims.

Additionally, the following areas are generally excluded, either in the stated exclusions or in other provisions:

- fines, penalties, and taxes;
- punitive or exemplary damage awards;
- criminal activity;
- willful or malicious acts;
- discrimination based on race, creed, age, sex, religion, or national origin;
- claims of alleged dishonesty, if it is established that the dishonesty was material;
- claims to recover benefits; and
- failure to collect employer contributions or to return overpayments.

Other policies can be obtained to cover those liabilities not normally covered in D&O policies. These include: securities acts liability insurance, individual director's policies, and non-profit and charitable organization policies. A recent D&O insurance product is personal director's liability insurance, which protects specific assets of the director and the director's spouse if the board of directors' D&O policy and the indemnification obligation of the company proves uncollectible.

Care must be taken in choosing the D&O insurer to be certain that they will have the financial resources necessary to honor the policy provisions. The cheapest policy is not necessarily the best if it is written by a financially weak insurer.

5. *Procedures illustrating due care*

Liability insurance itself is not sufficient to protect directors serving as audit committee members.[145] The insurance policies are often expensive and, as mentioned above, do not cover every conceivable potential liability confronting directors. It is therefore essential for audit committee members wishing to reduce the threat of liability to ensure that the committee creates a complete record of its activities, and conducts its duties according to identifiable procedures that satisfy its legal obligations. Some of the procedures that can be implemented are listed below.[146]

- *Definition of duties*: The audit committee should seek to have the duties that are delegated to it stated with particularity in writing in its charter.
- *Regularly scheduled meetings*: The committee should establish and publish a schedule of meetings. It can accompany this schedule with agendas setting forth the topics to be addressed at each meeting, the timetable to be observed, and the persons scheduled to appear.
- *Recordation of activity*: Minutes are normally kept at all meetings of the committee. These can be used not only to document the committee's activity, but also as references for future use. Generally, they should state the topics considered, the results of discussions, and the actions recommended. The committee can also institute a filing system with a complete index that catalogues the committee's activities. This not only provides an accessible record of past activity, but also can be of assistance in obtaining and retrieving reports and information that relate to current activity.
- *Establish independent information mechanisms*: One of the apparent mistakes made by the audit committees of

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[145] *See* Report of Investigation In re the Cooper Cos., Inc., as it Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 34-35,082 (Dec. 12, 1994), for a discussion of directors' failure ''to satisfy [their] obligations when confronted with serious indications of management fraud.'' This is what is known as the ''causing standard.''

[146] *See* ABA Overview Committee's Report, *supra* note 27, at 1860–61; Joseph Hinsey, *The Impact of the Audit Committee on Director Liability*, *in* THE EMERGENCE OF THE CORPORATE AUDIT COMMITTEE, at 48–49 (PLI Corp. Law & Practice Course, Handbook Series No. 273, 1978); *see generally* WILLIAM E. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 135–46 and Supp. at 380–94 (3d ed. 1978 & Supp. 1985).

Enron and WorldCom was their overdependence on the accuracy and completeness of information supplied by management and the independent auditors. The audit committee needs independent sources of information to perform its task of monitoring management. This could be supplied in part through a strong internal audit function, with the head of internal audit reporting directly to the audit committee. Some corporations outsource a portion of the internal audit function. The head of internal audit should be hired by the audit committee and have his or her compensation determined by the audit committee. The compensation of the head of internal audit should not contain significant incentives based upon financial results.

- *Create a culture of zero-fraud tolerance*: The audit committee, together with management, should set a tone within the corporation of zero-fraud tolerance. This can be accomplished by codes of ethics and constant reminders of the intolerance of the corporation for illegal or fraudulent conduct. The accessibility of the audit committee for directly reporting fraudulent conduct should be stressed in employee messages.

- *Limiting absences*: Committee members should avoid being absent from meetings. Roll calls should be taken and recorded in the committee's minutes. Directors who are unable to attend most of the meetings, either personally or by telephone, should resign or be replaced.

- *Obtaining advice of independent counsel, auditors, and experts*: Under Sarbanes-Oxley, audit committees have the option of retaining counsel other than the regular corporate counsel. Similarly, audit committees are permitted to engage independent auditors and other experts. Such professional expertise can assist the committee in accomplishing some of its more sophisticated functions.

- *Disclosure of the committee's role*: To eliminate any misconception of the audit committee's role, it might be necessary to explain the scope of its responsibilities. This can be done in full in the annual report or by reference to another document outlining the committee's functions.

- *Establish a ''due diligence'' defense to control-person liabilities*: Audit committees should conduct their activities to attempt to establish a ''due diligence'' defense to control-person liability. Periodic review of the activities of the audit committee should be made by counsel to determine if a ''due diligence'' defense has been established.