THE AUDIT COMMITTEE: DIRECTOR LIABILITY IN THE WAKE OF THE SARBANES-OXLEY ACT AND *TELLO V. DEAN WITTER REYNOLDS*

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The audit committee rose to prominence within the realm of corporate governance following the collapse of the Enron Corporation and subsequent ratification of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). The Sarbanes-Oxley Act represents the first independent statutory provision requiring the formation of an audit committee and imposes a significant set of responsibilities upon audit committee members. However, the interaction between these mandates and the historical rules of corporate and securities law have led to ambiguity surrounding the legal standards that govern the audit committee. In an age where the complexity of financial reporting seems to grow at an exponential rate, audit committee members must recognize the full extent of their responsibilities to corporate shareholders and personal exposure to liability.

This Note examines the legal treatment of the audit committee and its individual members under the Sarbanes-Oxley Act. In particular, I attempt to identify the impact of the Sarbanes-Oxley Act on the historical rules of corporate and securities law applicable to the audit committee.

I conclude that while the Sarbane's Oxley Act has increased the liability exposure of audit committee members, it fails to significantly heighten the standards under which the law scrutinizes their conduct.

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INTRODUCTION

Sitting on the board of a public corporation traditionally represents the "culmination of a successful career."[1] Classic board appointments confirm elevation to the business community's highest echelons,[2] and the status that accompanies directorship remains so coveted that monetary compensation is often the last consideration for potential candidates.[3] Nevertheless, the accounting scandals that rocked U.S. capital markets at the dawn of the new millennium have forced candidates to consider the extent to which positions on boards—and various board committees—may destroy both personal wealth and reputation.[4] Spawned in the wake of accounting scandal, such considerations have naturally served of most importance to potential audit committee members.

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[1] SCOTT GREEN, SARBANES-OXLEY AND THE BOARD OF DIRECTORS 1 (2005).

[2] *See id.*

[3] *See* Thomas J. Neff & Robert L. Heidrick, *Why Board Service Is Still Attractive*, CORP. BOARD, May/June 2006, at 3.

[4] *See* GREEN, *supra* note 1, at 1.

The collapse of the Enron Corporation (Enron) under the weight of accounting fraud generated a surge of corporate investigation[5] that elevated the audit committee to its present status as "the most important and challenging" committee of the board.[6] Following Enron's collapse and the multitude of accounting scandals subsequently revealed, a general hostility arose toward directors, who remain charged with overseeing the actions of executives under the corporate model.[7] Specifically, the public directed a significant amount of anger toward audit committee members in light of their unique role throughout the financial reporting process.[8]

In response to the public outcry, Congress quickly passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act),[9] which requires every public corporation to form an audit committee and governs the responsibilities of audit committee members.[10] Exacting public scrutiny and new governing law under the Sarbanes-Oxley Act have dramatically increased the burden associated with audit committee membership.[11] For example, audit committees must now meet more frequently and for longer periods.[12] The modern audit committee meeting also requires significantly more preparatory work.[13] In the past, meetings often consisted of mere presentations by executives and internal auditors—committee members received information and then asked questions in scripted fashion.[14] Current audit committee members, however, must typically engage in extensive research and questioning prior to meetings.[15] The modern audit committee meeting thus consists largely of discussion concerning the risks associated with adopting different accounting tech-

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5 *See* Perry E. Wallace, *Accounting, Auditing and Audit Committees After Enron, et al.: Governing Outside the Box Without Stepping off the Edge in the Modern Economy*, 43 WASHBURN L.J. 91, 102–03 (2004).

6 SPENCER STUART, THE GLOBAL 50: PERSPECTIVE OF LEADING AUDIT COMMITTEE CHAIRS 2 (2005).

7 *See id.* at 17.

8 *See* First Amended Consolidated Complaint for Violation of the Securities Laws, at 103–05, *In re* Enron Co. Sec. Litig., No. H-01-3624 (filed May 14, 2003) [hereinafter Enron, First Amended Consolidated Complaint]; First Amended Class Action Complaint of Lead Plaintiff Alan G. Hevesi on Behalf of Purchasers and Acquirers of all WorldCom, Inc. Publicly Traded Securities, at 15–26, 156, *In re* WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (filed Dec. 1, 2003) [hereinafter WorldCom, First Amended Class Action Complaint]; discussion *infra* Part I.B.2.

9 *See infra* note 87.

10 *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

11 *See* STUART, *supra* note 6, at 10.

12 *See id.*

13 *See id.*

14 *See id.* at 3.

15 *See id.*

niques.[16] Overall, the average time commitment associated with audit committee membership has increased by more than 50 percent.[17]

In addition to the increased time commitment, potential audit committee members must also consider the specter of uncertain liability that looms in the face of new governing law. The Sarbanes-Oxley Act raises important questions with respect to the legal treatment of audit committee members, which the Enron and WorldCom, Inc. (WorldCom) settlements only magnify. Enron directors, for example, paid approximately $13 million in personal assets towards satisfaction of the class action initiated after the corporation filed for bankruptcy.[18] WorldCom directors paid nearly $18 million in personal assets towards satisfaction of a similar class action.[19] Prior to these instances, state legislation authorizing corporate insurance policies[20] and indemnification[21] had rarely failed to protect the private assets of individual directors.[22]

This Note examines the legal treatment of the audit committee and its individual members under the Sarbanes-Oxley Act. Current and prospective audit committee members must fully understand the extent to which the law exposes both their reputations and assets. More importantly, audit committee members—given their unique role in the financial reporting process—must fundamentally appreciate all legal obligations owed to corporate shareholders.

Part I explores the function and history of the audit committee, while Part II examines the preemptory effect of the Sarbanes-Oxley Act with respect to those fiduciary duties that state law imposes upon audit committee members. Part III considers the impact of the Sarbanes-Oxley Act on prior federal securities legislation applicable to members of the audit committee. In particular, Part III evaluates those legal and policy considerations surrounding the circuit split left after *Tello v. Dean Witter Reynolds*, which involves the use of the extended statute of limitations found in the Sarbanes-Oxley Act to revive time-barred claims of securities fraud under Rule 10b-5 of the Securities and Exchange Act of 1934 (Exchange Act).

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[16] *See id.*

[17] *See id.* at 9.

[18] *See* Kurt Eichenwald, *Ex-Directors at Enron to Chip in on Settlement*, N.Y. TIMES, Jan. 8, 2005, at C1, *available at* http://www.nytimes.com/2005/01/08/business/08enron.html?_r=1&oref=slogin (last visited Mar. 3, 2009).

[19] *See id.*

[20] *See* DEL. CODE ANN. tit. 8, § 145(g) (2007); MODEL BUS. CORP. ACT § 8.57 (1984).

[21] *See* tit. 8, § 145(a)–(f); MODEL BUS. CORP. ACT § 8.51–8.52 (1984).

[22] *See* Eichenwald, *supra* note 18.

I. THE AUDIT COMMITTEE

A. *Function of the Audit Committee*

An audit is an examination of a corporation's management-generated financial statements by an independent public accounting firm.[23] The examination culminates with the production of an audit report in which the accounting firm expresses an opinion regarding the financial statements' accuracy.[24] While federal securities law requires all public corporations to procure audit reports,[25] the fundamental necessity of audits stems from the separation of management and ownership inherent to the corporate model.[26] Financial statements constitute "management's primary communication" with shareholders,[27] who only possess residual ownership rights to corporate assets.[28] Since management maintains operational control, it may employ improper accounting methods to create financial statements that distort corporate performance. Moreover, powerful incentives continually tempt individual managers to adopt these improper methods. Poor corporate performance may result in the dismissal of management, and the compensation packages offered to individual managers frequently contain incentive structures based upon a corporate earnings target.[29]

To prevent financial statement distortion, the Sarbanes-Oxley Act prescribes that every public corporation must establish an audit committee.[30] An audit committee is "a committee . . . established by and

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[23] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2(a)(2), 116 Stat. 745, 747 (2002). Auditors must conduct examinations in accordance with any applicable Securities and Exchange Commission (SEC) or Public Company Accounting Board regulations. *See id.* Prior to the establishment of the Public Company Accounting Board, auditors had to comply with Generally Accepted Auditing Standards. *See id.*

[24] *See id.* § 2(a)(4).

[25] *See id.*

[26] *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 99 (2d ed. 2007).

[27] HANDBOOK OF ACCOUNTING AND AUDITING 5-3 (Robert S. Kay & D. Gerald Searfoss eds., 2d ed. 1989).

[28] *See* ALLEN ET AL., *supra* note 26, at 114 ("Common stock holds . . . the residual claim on the corporation's assets and income.").

[29] *See id.* at 328 ("[M]anagers are more likely to 'game' incentive pay schemes as the monetary stakes increase, just as athletes are more likely to use performance-enhancing drugs as the monetary returns for victory increase.").

[30] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301(1)(a), 116 Stat. 745, 776 (2002). Section 301 further instructs the SEC to adopt rules requiring all national securities exchanges to prohibit the listing of any corporation that fails to comply with the audit committee requirement. *See id.*; Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8,220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 68 Fed. Reg. 18,788 (Apr. 9, 2003) (setting forth SEC Rule 10A-3, which requires national securities exchanges to comply with Section 301 of the Sarbanes-Oxley Act and provides further requirements with respect to director independence); NYSE, Inc., Listed Company Manual § 303A (2003) (requiring listed companies to comply with SEC Rule 10A-3 and

amongst the board of directors of [a corporation] for the purpose of overseeing the accounting and financial reporting process[ ] . . . and audits of the financial statements."[31] Section 301 of the Sarbanes-Oxley Act prescribes that each member of the audit committee must hold a seat on the board of directors and "otherwise be independent" of the corporation.[32] As a result, audit committee members may not—other than in their capacity as directors—accept any compensatory payments from the corporation or be otherwise affiliated with the corporation or its subsidiaries.[33] Section 407 of the Sarbanes-Oxley Act further directs the Securities and Exchange Commission (SEC) to adopt rules requiring public corporations "to disclose whether or not, and if not, the reasons therefor[e], the audit committee . . . is comprised of at least [one] member who is a financial expert."[34] This provision has the practical effect of requiring all public corporations to maintain at least one financial expert on their audit committee.[35] The audit committee is "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed" during the course of an audit.[36] Since management may attempt to coerce an auditor into approving improper accounting methods, the audit committee must resolve any "disagreements between management and the auditor regarding financial reporting [techniques]."[37] Furthermore, Section 301 requires the audit committee to create an adequate reporting system with respect to internal accounting and the audit process.[38] The reporting system must ensure that all complaints directed to the corporation regarding "accounting, internal accounting controls, or auditing matters" are adequately addressed.[39] The reporting system must also permit corporate employees to anonymously submit any concerns pertaining to internal accounting procedures or independent audits.[40] Finally, the audit committee may at

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setting forth additional requirements with respect to director independence); NASDAQ, INC., NASDAQ STOCK MARKET RULES, R. 4350(d) (2009), http://nasdaq.cchwallstreet.com/ (last visited Mar. 3, 2009) (requiring listed companies to comply with SEC Rule 10A-3 and setting forth additional requirements with respect to director independence).

[31] Sarbanes-Oxley Act § 2(a)(3).

[32] *Id.* § 301(3)(A).

[33] *See id.* § 301(3)(B). *See supra* note 30 for additional independence requirements set forth by national securities exchanges.

[34] Sarbanes-Oxley Act § 407(a); *see also* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8,177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5,110 (2003) (defining a financial expert in the context of an audit committee).

[35] *See* Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1175 (2004).

[36] Sarbanes-Oxley Act § 301(2).

[37] *Id.*

[38] *See id.* § 301(4).

[39] *See id.* § 301(4)(A).

[40] *See id.* § 301(4)(B).

any time engage the services of outside advisers and legal counsel to help ensure the fulfillment of its duties.[41]

B. *History of the Audit Committee*

1. Twentieth Century Rise of the Audit Committee

While the origins of modern audit committees remain difficult to determine with precision,[42] the first audit committees in the United States appeared during the early twentieth century.[43] Early twentieth-century statutes placed specific audit requirements on banks, insurance companies, and similar financial institutions.[44] Consequently, such organizations stood among the first corporations to establish audit committees.[45] Delegating authority to an audit committee helped preserve board effectiveness despite the greater responsibilities placed on individual directors and the increasing complexity of corporate financial statements.[46]

Throughout most of the twentieth century, however, the legal and accounting communities mounted only "[s]poradic efforts to define the need for" an audit committee operating within the board of every public corporation.[47] The New York Stock Exchange (NYSE) and SEC initially endorsed an unrefined concept of the audit committee in response to the 1939 investigation of McKesson & Robbins Inc., the SEC's first significant accounting fraud inquiry.[48] Nevertheless, it was not until 1972 that the SEC first recommended every public corporation establish an audit committee.[49] Adherence to this recommendation also remained optional despite growing recognition of the need to more appropriately

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[41] *See id.* § 301(5).

[42] *See* HANDBOOK OF ACCOUNTING AND AUDITING, *supra* note 27, at 6-2.

[43] *See* FRANK M. BURKE & DAN M. GUY, AUDIT COMMITTEES: A GUIDE FOR DIRECTORS, MANAGEMENT, AND CONSULTANTS 9 (2d ed. 2002).

[44] *See id.*

[45] *See id.* For example, the Prudential Insurance Company of America first established its audit committee nearly one hundred years ago. *See id.*

[46] *See* HANDBOOK OF ACCOUNTING AND AUDITING, *supra* note 27, at 6-1.

[47] BURKE & GUY, *supra* note 43, at 19.

[48] *See In re* McKesson & Robbins, Inc., Exchange Act Release No. 2,707, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 62,104, at 62,108 (Dec. 5, 1940) ("[Many companies would benefit from the] [e]stablishment of a committee . . . selected from non[-]officer members of the board of directors which shall make all . . . nominations of auditors and shall be charged with . . . arranging the details of the engagement."); *see also* ROCCO R. VANASCO, THE AUDIT COMMITTEE: AN INTERNATIONAL PERSPECTIVE 2 (1994) ("[S]election of the auditors by a special committee composed of directors who are not officers of the company seems [to be an] acceptable [practice].") (quoting Report of the Subcommittee of the NYSE on Independent Audits and Audit Procedures of the Committee on Stock List (1940)).

[49] *See* Standing Audit Committees Composed of Outside Directors, Securities Act Release No. 5,237, Exchange Act Release No. 9,548, Investment Company Act Release Act No. 7,091, 37 Fed. Reg. 6,850 (Mar. 23, 1972) ("[T]he Commission . . . endorses the establishment by all publicly-held companies of audit committees composed of outside directors . . . .").

delegate board responsibilities.[50] While the NYSE required the formation of an audit committee after 1977,[51] the National Association of Securities Dealers and the American Stock Exchange did not adopt similar listing requirements until the late 1980s.[52] Listing requirements, moreover, only represent private contractual terms between corporations and the exchanges upon which their securities trade.[53] The twentieth century thus closed without codification of any independent legal authority requiring the formation of an audit committee.

The twentieth century also witnessed few scholarly attempts to articulate the specific responsibilities of an audit committee after its formation.[54] Initial endorsements of the audit committee noted only that a group of independent directors should select all public accounting firms contracted to conduct audits.[55] It was not until 1987 that the National Commission on Fraudulent Financial Reporting (commonly known as the "Treadway Commission") suggested the first set of guidelines regarding audit committee duties and best practices.[56] The Treadway Commission reasoned that the mere formation of an audit committee is insufficient to protect shareholder interests,[57] as the committee must thereafter remain "vigilant, informed, diligent, and probing [when] fulfilling its oversight responsibilities."[58]

The Treadway Commission guidelines recommended that audit committees consist of at least three independent directors who all receive continuous training in both financial reporting and company-specific operations.[59] Moreover, the Treadway Commission suggested audit committee responsibilities should include the periodic review of auditor independence and effectiveness, the adequacy of internal accounting

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[50] *See, e.g.*, S.E.C. v. Mattel, Inc., No. 74, 1974 WL 449, at *6 (D.D.C. Oct. 1, 1974) (exemplifying the SEC's strategy during the 1970's of seeking securities litigation settlements that provided for the establishment of audit committees); Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants, Securities Act Release No. 5,550, Exchange Act Release No. 11,147, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 62,394, at 62,397 (Dec. 20, 1974) (requiring a registered company to disclose in its proxy statements the names of its audit committee members or state that no such committee existed).

[51] *See* VANASCO, *supra* note 48, at 2.

[52] *See* BURKE & GUY, *supra* note 43, at 28–30.

[53] *See* Johnson & Sides, *supra* note 35, at 1210.

[54] *See* BURKE & GUY, *supra* note 43, at 19.

[55] *See* VANASCO, *supra* note 48, at 2.

[56] *See* REPORT OF THE NAT'L COMM'N ON FRAUDULENT FIN. REPORTING 176 (1987), *available at* http://www.coso.org/Publications/NCFFR.pdf. The Treadway Commission was a "private sector initiative" that received joint sponsorship from the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants. *See id.* at 1.

[57] *See id.* at 41.

[58] *Id.*

[59] *See id.* at 182–83.

controls, and the legitimacy of officer expense account policies.[60] The guidelines further recommended that the audit committee meet frequently, confer with auditor representatives in private, and regularly report its findings to the entire board.[61] Finally, the Treadway Commission suggested the full board of directors create a written audit committee charter explicitly setting forth all requirements and delegated responsibilities, including those suggestions taken from the proposed guidelines and any alternatives specific to the corporation.[62]

2. Scandal in the New Millennium and Implementation of the Sarbanes-Oxley Act

Foreshadowing the vast scandal to come, SEC chairman Arthur Levitt made a significant speech in 1998 addressing the disclosure of corporate earnings.[63] Chairman Levitt warned of an "erosion in the quality of . . . financial reporting"[64] that stemmed from the increased pressure placed upon corporate managers to meet Wall Street expectations.[65] Specifically, he identified several of the more popular accounting methods used to distort corporate financial statements.[66] Chairman Levitt further noted that a "qualified, committed, independent and tough-minded audit committee[ ] represent[s] the most reliable guardian[ ] of the public interest."[67] As a result, the SEC included strengthening the audit committee in its nine-part action plan to improve the reliability and transparency of financial statements.[68] The plan called for each audit

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[60] *See id.*

[61] *See id.* at 183.

[62] *See id.* at 42–43.

[63] *See* Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at the NYU Center for Law & Business: The "Numbers Game" (Sept. 28, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt (last visited Mar. 3, 2009).

[64] *Id.*

[65] *See id.*

[66] *See id.* The first of the more popular techniques corporations use to distort their financial positions is the "Big Bath" restructuring charge. *Id.* During some form of internal restructuring corporations overstate the costs and associate these expenses with depressed revenue in hope that the market will look beyond the one-time charge. *See id.* Second, corporations engage in a form of "creative acquisition accounting" that reports a portion of the acquisition price as a one time 'in process' research and development expense. *Id.* Third, corporations use unrealistic assumptions to estimate certain liabilities. *See id.* Fourth, corporations abuse the accounting principle that only material items need be included in financial statements. *See id.* Fifth, corporations improperly accelerate the recognition of revenues to offset poor earnings. *See id.*

[67] *Id.*

[68] *See id.* The plan further called for corporations to disclose the impact of all changes in accounting assumptions and for the accounting profession to set strict rules for the auditing of research and development purchases, revenue recognition, and restructuring expenses. *See id.* Additionally, it required corporations to consider the quality of items and not merely the quantity when evaluating materiality for accounting purposes. *See id.* The plan also called for an increased emphasis on corporate responsibility and the training of auditors. *See id.*

committee member to possess a financial background and maintain no personal ties with the corporate chairman.[69] It further called upon the audit committee to meet frequently, employ its own outside advisers, and ask "tough questions of management and outside auditors."[70]

Despite Chairman Levitt's call for strengthened audit committees as a means to combat the diminishing quality of financial disclosure, Enron filed for bankruptcy in 2001 and spawned an unprecedented wave of investigation into the accounting practices of public corporations.[71] Enron announced a restatement of prior financial results in November 2002 that eliminated $1.2 billion in shareholder equity.[72] Within six weeks, subsequent investigations into the corporation's true financial position drove it into bankruptcy.[73] Corporate managers had accrued over $2 billion from personal sales of Enron stock and bonus payments tied to earnings.[74] In facilitating such personal gain, management had employed an assortment of fraudulent accounting and auditing techniques[75] to report billions of dollars in fictitious revenue and conceal similar quantities of debt.[76] These techniques artificially inflated earnings, which resulted in increased share prices.[77] The inflated value of Enron stock, however, vanished instantly during bankruptcy proceedings.[78] The value of publicly held Enron debt instruments decreased significantly as well.[79] Purchasers of Enron debt and equity securities lost billions of dollars in the aggregate.[80]

The most notable accounting inquiry to follow in the wake of Enron's collapse was the WorldCom investigation.[81] Over a four year period, WorldCom management employed a number of fraudulent

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[69] *See id.*

[70] *See id.*

[71] *See* Wallace, *supra* note 5, at 102–03. Investigations began with respect to the accounting practices of a vast array of well-established public corporations including: Global Crossing, Tyco, Merrill Lynch, Adelphia Communications, Quest Communications, ImClone Systems, Xerox, WorldCom, and AOL Time Warner. *See id.*

[72] *See* Enron, First Amended Consolidated Complaint, *supra* note 8, at 51.

[73] *See id.* at 55.

[74] *See id.* at 15.

[75] In particular, Enron managers abused mark-to-market accounting methods to improperly accelerate revenue recognition. *See id.* at 28–29. Managers also engaged in transactions with controlled partnerships and special purpose entities that resulted in the appearance of greater corporate revenues and less corporate debt. *See id.* at 5.

[76] *See id.* at 55.

[77] *See id.* at 4–5.

[78] *See id.* at 53.

[79] *See id.*

[80] *See id.* at 6.

[81] *See* WorldCom, First Amended Class Action Complaint, *supra* note 8.

accounting techniques to overstate earnings by nearly $9 billion.[82] Nevertheless, subsequent investigations into the corporation's true financial position drove WorldCom to file during 2002 for the then largest bankruptcy in U.S. history.[83] Investors holding WorldCom debt and equity securities lost billions of dollars in the aggregate.[84]

The wave of investigation into corporate accounting practices significantly hastened development of independent legal authority governing audit committee formation and responsibility. Complaints filed against the Enron and WorldCom directors for securities fraud and related claims specifically designated members of the audit committee in highly publicized class action suits.[85] The WorldCom complaint, for example, devoted seventeen pages to specifically detailing the way in which "[t]he [a]udit [c]ommittee's [f]ailure to [f]ulfill its [r]esponsibilities [a]llowed . . . [f]raud to [g]o [u]ndetected."[86] In response to the subsequent public outcry, Congress quickly passed the Sarbanes-Oxley Act.[87] Section 301 offered the first independent statutory provision requiring every public corporation to establish an audit committee.[88] More importantly, Section 301 finally set forth the specific responsibilities of an audit committee after its formation.[89]

II. AUDIT COMMITTEE LIABILITY: STATE CORPORATE LAW

A. Fiduciary Duties and the Committee Structure

1. Director Fiduciary Duties

Each member of a corporate board maintains a fiduciary relationship with the corporation and must therefore act in accordance with the fiduciary duties of obedience, care, and loyalty set forth under the applicable state law.[90] The duty of obedience requires directors to "act consistently with the legal documents that create [t]he[i]r authority."[91] As a result, directors must perform any tasks the corporate charter requires of

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[82] *See id.* at 2. In particular, WorldCom managers improperly released depreciation reserves and accruals. *See id.* at 35. Managers also improperly capitalized billions of dollars in expenses. *See id.* at 36.

[83] *See id.* at 4.

[84] *See id.* at 2.

[85] *See* Enron, First Amended Consolidated Complaint, *supra* note 8, at 103–05; WorldCom, First Amended Class Action Complaint, *supra* note 8, at 15–26.

[86] WorldCom, First Amended Class Action Complaint, *supra* note 8, at 156.

[87] *Accounting Reform and Investor Protection, Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 1 (2002) (opening statement of Paul S. Sarbanes, Chairman, S. Comm. on Banking, Housing, and Urban Affairs).

[88] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (2002).

[89] *See id.*

[90] *See* ALLEN ET AL., *supra* note 26, at 241.

[91] *Id.*

them—such as holding an annual shareholder's meeting—even if they believe diverging from the requirements set forth would benefit the corporation.[92]

The duty of care requires directors to serve the corporation "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[93] Duty of care claims raise questions of director malpractice with respect to corporate losses generated in two contexts: (1) the execution of business decisions and (2) fulfillment of the oversight function.[94] To prevent excessive risk aversion from fear of liability, the business judgment rule largely insulates directors from duty of care claims following the execution of a business decision.[95] The rule presumes that a valid business judgment arises when directors are financially disinterested with respect to a matter, become duly informed before taking any action with respect to that matter, and then proceed in good faith on behalf of the corporation.[96] Courts first ascertain whether directors were financially disinterested and acting in good faith.[97] Once a court determines that directors were financially disinterested with respect to a decision and acted in good faith, the business judgment rule will generally offer protection absent evidence of gross negligence.[98]

The duty of care further requires directors to exercise reasonable oversight with respect to corporate dealings and respond appropriately to any concerns discovered.[99] As a result, no liability exists in the absence of red flags which the exercise of reasonable oversight would uncover.[100] Reasonable oversight entails the creation of reporting systems that provide directors with the information necessary to monitor the corporation and compliance programs that ensure the corporation's adherence to applicable law.[101] The sophistication of any reporting system or compli-

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[92] *See id.*

[93] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994).

[94] *See* ALLEN ET AL., *supra* note 26, at 263–64.

[95] *See id.* at 243, 245.

[96] *See* AM. BAR ASSOC., CORPORATE DIRECTOR'S GUIDEBOOK 26 (5th ed. 2007).

[97] *See* ALLEN ET AL., *supra* note 26, at 255. There is no set definition of good faith, but bad faith generally includes "intentionally act[ing] with a purpose other than that of advancing the best interests of the corporation, . . . act[ing] with the intent to violate applicable positive law, or . . . intentionally fail[ing] to act in the face of a known duty to act." *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) (footnotes omitted).

[98] *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("We think the concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one.").

[99] *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.").

[100] *See id.*

[101] *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

ance program, however, remains a matter of business judgment.[102] Directors may freely seek to balance the resources invested in reporting systems and compliance programs with the expected losses from potential oversight failures in a cost-effective fashion.[103] Thus, once a reporting system or compliance program exists, directors generally bear no liability for losses sustained from any deficiencies absent evidence of gross negligence.[104]

The duty of loyalty requires directors "to exercise [their authority] over corporate processes or property (including information) in a good-faith effort to advance the interests of the company."[105] The duty of loyalty thus prevents directors from enriching themselves to the detriment of the corporation.[106] More specifically, duty of loyalty concerns commonly arise in several general contexts. First, courts apply the corporate waste doctrine to evaluate all charitable donations that directors approve on behalf of a corporation.[107] No corporate waste—and thus no liability under the duty of loyalty—exists provided the donation is reasonable in magnitude.[108] Second, courts also apply the corporate waste doctrine to all management compensation awards that directors approve.[109] Corporations must receive some reasonable value in consideration of a compensation package, as courts are more likely to find waste when large compensation packages begin to look like gifts.[110] Third, courts evaluate all self-dealing transactions under the entire fairness standard.[111] Since a self-dealing transaction is one in which directors maintain interests on both sides of the agreement,[112] those directors facing conflicts of interest must demonstrate that any self-dealing transaction is entirely fair to the corporation.[113] Failure to disclose all material infor-

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[102] *See id.*

[103] *See id.*

[104] *See id.* at 971.

[105] ALLEN ET AL., *supra* note 26, at 293.

[106] *See id.*

[107] *See* DEL. CODE ANN. tit. 8, § 122(9) (2007) ("[Corporations maintain the authority] to [m]ake donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof . . . ."); *see also* Kahn v. Sullivan, 594 A.2d 48, 61 (Del. 1991) (holding that while corporations possess the statutory authority to make charitable donations, the corporate waste doctrine dictates the magnitude of a donation is appropriate only if reasonable).

[108] *See Kahn*, 594 A.2d at 61.

[109] *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327, 338 (Del. Ch. 1997) (describing current Delaware law applying the waste doctrine to option grants).

[110] *See id.* at 336.

[111] *See*, *e.g.*, Fliegler v. Lawrence, 361 A.2d 218, 221–22 (Del. 1976) (holding that directors must demonstrate any self-dealing transaction was entirely fair to the corporation, even if the disinterested board members approved the transaction after full disclosure of all material information concerning conflicting interests).

[112] *See* BLACK'S LAW DICTIONARY 642 (3d pocket ed. 2006).

[113] *See Fliegler*, 361 A.2d at 221–22.

mation pertinent to conflicts of interest will preclude a finding of fairness.[114] Fourth, directors face liability for duty of loyalty breaches if they usurp a corporate opportunity.[115] When a director pursues a business opportunity in an individual capacity, courts employ a variety of tests to determine if—given the director's position as a fiduciary—that opportunity in fact belongs to the corporation.[116]

2. Interplay Between Fiduciary Duties and the Committee Structure

Unless prohibited by the charter or bylaws, a corporate board maintains the authority to create committees composed of one or more directors.[117] Committees may then exercise the full powers of the board to the extent specified.[118] While the purpose of the committee structure is to efficiently fulfill board responsibilities,[119] delegation of authority to a committee does not relieve the remaining directors from their fiduciary duties.[120] Thus, delegating responsibility over a matter to a committee of the board will not relieve the remaining directors of their fiduciary duties with respect to that matter.[121] The remaining board members are, however, safe from liability concerns when they act in good faith reliance upon any statements or information that a committee presents.[122] Similarly, committee members do not face liability when they act in good

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[114] *See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937–39 (Del. 1985) (finding entire fairness when corporate board received full disclosure of all potential conflicts).

[115] *See* ALLEN ET AL., *supra* note 26, at 351.

[116] *See id.* First, the expectancy test dictates that, at minimum, a corporation has an expectation its directors will not use their knowledge of corporate plans to pursue business opportunities that are harmful to it. *See id.* Second, the line of business test dictates that directors may not usurp any opportunities that fall within the corporation's line of business. *See id.* at 351–52. Third, the fairness test serves as a catch all test that courts often employ to evaluate all the relevant circumstances before determining whether a director has improperly usurped a corporate opportunity. *See id.* at 352.

[117] *See* DEL. CODE ANN. tit. 8, § 141(c)(1)–(2) (2007); MODEL BUS. CORP. ACT § 8.25(a) (1984).

[118] *See* tit. 8, § 141(c)(1)–(2); MODEL BUS. CORP. ACT § 8.25(d) (1984). The authority to exercise the full powers of the board is subject to certain exceptions. Committees of the board may only authorize distributions under certain conditions. *See* tit. 8, § 141(c)(1); MODEL BUS. CORP. ACT § 8.25(e)(1) (1984). Committees of the board may not adopt or propose to the shareholders any action that requires a shareholder vote. *See* tit. 8, § 141(c)(1)–(2)(i); MODEL BUS. CORP ACT § 8.25(e)(2) (1984). Committees of the board may not fill board vacancies. *See* MODEL BUS. CORP ACT § 8.25(e)(3) (1984). Committees of the board may not alter the corporate charter or bylaws. *See* tit. 8, § 141(c)(1)–(2)(ii); MODEL BUS. CORP ACT § 8.25(e)(4)–(5) (1984).

[119] *See* HANDBOOK OF ACCOUNTING AND AUDITING, *supra* note 27, at 6-1 ("Committees are formed to fulfill, not expand, the board's responsibilities.").

[120] *See* MODEL BUS. CORP. ACT § 8.25(f) (1984).

[121] *See id.*

[122] *See* tit. 8, § 141(e); MODEL BUS. CORP. ACT § 8.30(a)–(b) (1984).

faith reliance upon information from fellow committee members, other directors, or other corporate employees.[123]

B. The Intrusion of Sarbanes-Oxley: Section 301

The Sarbanes-Oxley Act "makes unprecedented federal inroads into [traditionally state-regulated areas] of corporate governance."[124] Provisions applicable to audit committee members that conflict with state corporate law thus raise important questions of federal preemption.

Several preemption issues, for example, arise in connection with the delegation of board authority to an audit committee. First, provisions of the Sarbanes-Oxley Act raise concern as to whether formation of an audit committee remains an independent power of the board. State corporate law typically provides that a board *may* create committees composed of one or more directors.[125] Section 301 of the Sarbanes-Oxley Act, however, prescribes that a public corporation *must* establish an audit committee.[126] The inherent tension in statutory language calls into question whether Section 301 functions independently to create an audit committee within the board of every public corporation. Second, Section 301 prescribes that the audit committee must establish a reporting system with respect to accounting concerns and "shall be directly responsible for the appointment, compensation and oversight" of auditors.[127] Since the audit committee maintains responsibility for both the audit process and any additional accounting concerns, reasonable interpretations of Section 301 could conclude that it relieves the remaining directors of all fiduciary responsibilities with respect to financial reporting.[128] Third, Section 301 confers responsibilities upon the audit committee *as a whole*.[129] Since state corporate law protects committee members who rely upon one another in good faith,[130] Section 301 raises concern over the extent to which individual audit committee members retain liability for actions the committee takes in good faith reliance upon its financial expert.[131]

Preemption issues also arise in connection with audit committee members' fiduciary duty of care. Section 301 explicitly confers responsibilities upon the audit committee, and traditional state law principles

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[123] *See* tit. 8, § 141(e).

[124] Johnson & Sides, *supra* note 35, at 1150.

[125] *See* tit. 8, § 141(c)(1)–(2); MODEL BUS. CORP. ACT § 8.25(a) (1984).

[126] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (2002).

[127] *Id.*

[128] *See* Johnson & Sides, *supra* note 35, at 1217.

[129] *See* Sarbanes-Oxley Act of 2002, § 301(2) ("The audit committee . . . in its capacity as a committee . . . shall be directly responsible [for the audit process] . . . .").

[130] *See* tit. 8, §141(e); *see also* MODEL BUS. CORP. ACT § 8.30(c)–(e) (1984).

[131] *See* Johnson & Sides, *supra* note 35, at 1218.

dictate that audit committee members must fulfill these responsibilities in accordance with the duty of care.[132] However, SEC regulations promulgated under the Sarbanes-Oxley Act require directors to manage a system of internal controls that provide "reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements."[133] The liability standard articulated in the regulations does not equate to the liability standards set forth under the duty of care, which raises ambiguity concerning the extent to which the regulations promulgated under the Sarbanes-Oxley Act preempt the duty of care.

C. Preemption Doctrine

The preemption doctrine dictates when federal statutes displace state law.[134] Consequently, preemption represents a significant form of federalism, as it sways the structural balance of power within the framework of dual sovereignty set forth in the Constitution.[135] The preemption doctrine stems from the Supremacy Clause,[136] which provides that "the Laws of the United States . . . shall be the supreme Law of the Land."[137] This Constitutional provision does not, however, empower Congress to enact preemptive legislation.[138] The Supremacy Clause only prescribes the result when state and federal laws conflict.[139] The authority to enact preemptive statutes lies within the legislative powers granted to Congress in Article I, Section 8 of the Constitution.[140] As a result, preemption decisions generally turn on issues of statutory construction—

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[132] *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 93, § 4.01.

[133] Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8,238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 11 Fed. Reg. 10,921 (June 8, 2003).

[134] *See* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 9.1, at 374 (7th ed. 2004).

[135] *See* JAMES T. O'REILLY, FEDERAL PREEMPTION OF STATE AND LOCAL LAW: LEGISLATION, REGULATION AND LITIGATION 1 (2006).

[136] *See, e.g.*, Lorillard Tobacco Co. v. Reilly, 533 U.S. 525 (2001); Gade v. Nat'l Solid Wastes Mgmt. Ass'n, 505 U.S. 88 (1992); Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982); CHRISTOPHER R. DRAHOZAL, THE SUPREMACY CLAUSE: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 94 (Jack Stark ed. 2004). *But see* Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767, 769 (1994) (arguing the minority position that preemption doctrine "has little if anything to do with the Supremacy Clause").

[137] U.S. CONST. art. VI, cl. 2.

[138] *See id.*; *see also* Viet D. Dinh, *Reassessing the Law of Preemption*, 88 GEO. L.J. 2085, 2088–91 (2000).

[139] *See* Dinh, *supra* note 138, at 2090.

[140] *See id.* at 2091 ("Preemption is not a substantive power of Congress, but rather a method of regulation in furtherance of some other substantive congressional authority. The power to preempt, therefore, is necessarily pendant on some enumerated power to regulate under Article I, Section 8." (footnote omitted)).

courts must determine when federal statutes and state law actually conflict within the meaning of the Supremacy Clause.[141]

The Supreme Court adopted a categorical approach to determine whether federal statutes and state law conflict within the meaning of the Supremacy Clause.[142] First, courts will find express preemption when Congress "explicitly define[s] the extent to which its enactments preempt state law."[143] Congress often communicates its intent to preempt state law by adding explicit preemption clauses to federal legislation.[144] Second, even if federal legislation fails to evidence explicit Congressional intent, courts may find implied preemption.[145] Congress can preclude a finding of implied preemption by adding a preemption savings clause or an anti-preemption clause to federal legislation.[146]

Implied preemption arises in two forms: field preemption and conflict preemption.[147] Field preemption of all state law pertaining to a particular subject occurs if Congress intended a piece of federal legislation to "occupy the field" with respect to that subject.[148] When determining the existence of field preemption, courts will consider any statement of Congressional intent to occupy a field.[149] Courts then evaluate whether the federal government maintains a dominant interest in occupying that field.[150] Finally, courts consider whether the pervasiveness of federal regulation in the field evidences Congressional intent to occupy it.[151] Conflict preemption arises in two instances. First, it occurs when adherence to state law completely prohibits compliance with federal requirements.[152] Second, it occurs when adherence to state law impedes achievement of the Congressional objective behind a piece of legislation.[153] The outcome of judicial decisions involving conflict preemption generally turns on how broadly or narrowly a court construes those Congressional objectives underlying a federal statute.[154]

When employing the categorical approach, courts apply a presumption against preemption in areas "which the States have traditionally oc-

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141 *See* DRAHOZAL, *supra* note 136, at 94; *see also* NOWAK & ROTUNDA, *supra* note 134, § 9.1, at 374.

142 *See* English v. Gen. Elec. Co., 496 U.S. 72, 78–79 (1990); *see also* DRAHOZAL, *supra* note 136, at 95–96.

143 *English*, 496 U.S. at 78.

144 *See* DRAHOZAL, *supra* note 136, at 97.

145 *See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 152–53 (1982).

146 *See* O'REILLY, *supra* note 135, at 18–19.

147 *See English*, 496 U.S. at 79.

148 *See id.*

149 *See* O'REILLY, *supra* note 135, at 70.

150 *See* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

151 *See id.*

152 *See* Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142–43 (1963).

153 *See* Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

154 *See* O'REILLY, *supra* note 135, at 75–76.

cupied."[155] Once applied, the presumption requires a stronger showing before there can be any finding of preemption.[156] While courts typically apply the presumption with respect to state police powers,[157] they often apply it in other areas as well.[158] The presumption is more likely to apply if a finding of preemption would preclude recovery by potential plaintiffs.[159]

The categorical approach also applies when determining whether federal administrative regulations and state law conflict within the meaning of the Supremacy Clause.[160] Administrative regulations adopted under statutory delegations of authority may displace state law in the same manner as Congressional legislation.[161] An administrative agency, however, can only preempt state law to the extent minimally necessary to achieve the goals of those statutes pursuant to which it enacts regulations.[162]

D. *Analysis: Sarbanes-Oxley, Fiduciary Duties, and the Audit Committee*

The Sarbanes-Oxley Act does not contain a provision that explicitly defines the extent to which it preempts state corporate law.[163] As a result, the interplay between the Sarbanes-Oxley Act and state corporate law involves issues of implied preemption.[164] Since the Sarbanes-Oxley Act and related SEC regulations evidence no intention "to occupy the field" traditionally governed under state corporate law, implied field preemption seems unlikely.[165] Moreover, courts must apply a strong pre-

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[155] *Rice*, 331 U.S. at 230.

[156] *See id.*; *see also* DRAHOZAL, *supra* note 136, at 111.

[157] *See* DRAHOZAL, *supra* note 136, at 112.

[158] *See, e.g.*, Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 541 (2001) (applying the presumption against preemption to laws regulating advertising); California v. ARC Am. Co., 490 U.S. 93, 101 (1989) (applying the presumption against preemption to laws regulating monopolies and cartels).

[159] *See* O'REILLY, *supra* note 135, at 7–8.

[160] *See id.* at 14.

[161] *See id.*

[162] *See* Exec. Order No. 13,132, 3 C.F.R. 206 (2000), *reprinted in* 5 U.S.C. § 601 (2000).

[163] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); *see also* Johnson & Sides, *supra* note 35, at 1209.

[164] *See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 152–53 (1982).

[165] *See* English v. Gen. Elec. Co., 496 U.S. 72, 79 (1990). The legislative history of the Sarbanes-Oxley Act contains no evidence suggesting that Congress wished to completely usurp any area of state corporate law. *See* Johnson & Sides, *supra* note 35, at 1210. SEC administrative regulations have similarly demonstrated respect for various areas of state corporate law. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8,177A, Exchange Act Release No. 47,235A, 68 Fed. Reg. 5,110 (Jan. 31, 2003) ("[With respect to determining who qualifies as an audit committee financial expert,] we think that it is appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.").

sumption against field preemption[166] because "[n]o principle of corporat[e] law and practice is more firmly established than a State's authority to regulate [its] domestic corporations."[167] The Sarbanes-Oxley Act thus preempts state corporate law only to the extent that conflicts exist.[168]

Despite any tension between Section 301 and state corporate statutes, the ability to form an audit committee remains an independent power of the board—the Sarbanes-Oxley Act does not independently create audit committees within public corporations.[169] Only a partial conflict exists between Section 301, which requires public corporations to establish an audit committee,[170] and state statutes that permit corporate boards to create committees composed of one or more directors.[171] Section 301 merely directs boards how to exercise the option to create a committee in one highly-specific context. As a result, the Sarbanes-Oxley Act only preempts state law to the extent it denies boards the option to forgo creation of an audit committee under the authority of state corporate law. Despite the language of Section 301, the audit committee remains a committee that is "established by . . . the board of directors."[172]

Furthermore, Section 301 fails to relieve directors who are not audit committee members of their fiduciary duties with respect to financial reporting. Section 301 indeed conveys direct responsibility upon the audit committee for establishment of reporting systems with respect to accounting concerns as well as the "appointment, compensation and oversight" of all auditors.[173] Nevertheless, the audit committee remains a committee of the board by definition.[174] Since delegating authority to a committee fails to relieve the remaining directors from any of their fiduciary duties,[175] directors who are not audit committee members must still fulfill their fiduciary duties with respect to financial reporting.[176] No conflict exists between the relevant state and federal provisions.

While Section 301 confers responsibility with respect to financial reporting on the audit committee as a *whole*, state corporate law still

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166 *See* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

167 CTS Co. v. Dynamics Co., 481 U.S. 69, 89 (1987).

168 *See English*, 496 U.S. at 79.

169 *See* Johnson & Sides, *supra* note 35, at 1217.

170 *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (2002).

171 *See* DEL. CODE ANN. tit. 8, § 141(c)(1)–(2) (2007); MODEL BUS. CORP. ACT § 8.25(a) (1984).

172 Sarbanes-Oxley Act § 2(a)(3).

173 *Id.* § 301.

174 *See id.* § 2(a)(3).

175 *See* MODEL BUS. CORP. ACT § 8.25(f) (1984).

176 *See* Johnson & Sides, *supra* note 35, at 1217.

protects individual members when the committee takes action in good faith reliance upon its financial expert. Section 301 indeed confers responsibilities upon the audit committee as a *whole*.[177] Once again, however, the audit committee remains a committee of the board by definition.[178] Since state corporate law protects committee members who rely upon one another in good faith,[179] audit committee members who act in good faith reliance upon the committee's financial expert remain insulated from liability under their fiduciary duties.[180] No conflict exists between the relevant state and federal provisions. The Sarbanes-Oxley Act dictates that audit committee members must fulfill their responsibilities as a group, but state corporate law determines how fiduciary duties apply to the process of reaching a consensus.

Finally, SEC regulations promulgated under the Sarbanes-Oxley Act have only a limited preemptory effect on the liability standards set forth by audit committee members' fiduciary duty of care. Any audit committee member who knowingly violates a provision of the Sarbanes-Oxley Act or its associated regulations will face liability under the duty of care, as knowing violations of positive law constitute a breach of the duty.[181] Nevertheless, SEC regulations require directors to manage a system of internal financial controls that provide "reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements."[182] While commentators have suggested that the liability standard set forth in these regulations may preempt directors' fiduciary duty of care with respect to the oversight function,[183] such a conclusion is technically incorrect. The duty of care requires that directors respond appropriately to any red flags that reasonable oversight would uncover.[184] Although reasonable oversight under the duty of care necessitates the implementation of internal controls, the sophistication of those controls traditionally remains a matter of business judgment.[185] The SEC regulations, however, speak only to the sophistication of inter-

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[177] *See* Sarbanes-Oxley Act § 301(2) ("The audit committee . . . in its capacity as a committee . . . shall be directly responsible [for the audit process] . . . .").

[178] *See id.* § 2(a)(3).

[179] *See* DEL. CODE ANN. tit. 8, § 141(e) (2007); MODEL BUS. CORP. ACT § 8.30(c)–(e) (1984).

[180] *See* Johnson & Sides, *supra* note 35, at 1218.

[181] *See* ALLEN ET AL., *supra* note 26, at 291–92.

[182] Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8,238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 11 Fed. Reg. 10,921 (June 8, 2003).

[183] *See* Johnson & Sides, *supra* note 35, at 1216.

[184] *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (1963) ("[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.").

[185] *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

nal controls and not the overall liability standard applied to directors when monitoring corporate affairs. Thus, the SEC regulations actually conflict with the *business judgment rule* in a very specific situation—when directors implement internal controls as part of their oversight responsibilities.

In light of the SEC regulations, audit committee members—like all directors—must still exercise the reasonable oversight required under the duty of care, which continues to necessitate the implementation of internal controls. The sophistication of those controls, however, is no longer a matter of business judgment. The SEC regulations preempt the business judgment rule in this narrow context. As a result, audit committee members formulating internal control provisions pursuant to delegated authority must adopt measures with a sophistication level that reasonably assures the accuracy of financial reports. Decisions concerning control sophistication no longer receive business judgment rule protection.

III. AUDIT COMMITTEE LIABILITY: FEDERAL SECURITIES LAW

A. Federal Securities Legislation

All corporate directors face potential liability under federal securities legislation. Currently, the Securities Act of 1933 (Securities Act)[186] and the Exchange Act[187] serve as the principle sources of most federal regulation in the securities industry.[188] While the Securities Act governs all initial sales of securities,[189] the Exchange Act governs subsequent securities trading in secondary markets.[190] The central purpose of both acts, however, is to ensure that public corporations accurately disclose sufficient information for current and potential shareholders to make informed decisions.[191] As a result, federal securities law remains particularly applicable to audit committee members, whose responsibilities include the review of financial statements that represent the primary form of communication with shareholders.[192]

The most significant source of potential audit committee liability under the Securities Act stems from Section 11.[193] Prior to effecting any public securities offering through interstate commerce, corporations must

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[186] *See* Securities Act of 1933, 48 Stat. 74 (1933).

[187] *See* Securities and Exchange Act of 1934, 48 Stat. 881 (1934).

[188] *See generally* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 1 (2d ed. 1996).

[189] *See* Securities Act of 1933, 48 Stat. 74 (1933); *see also* STEINBERG, *supra* note 188, at 1.

[190] *See* Securities and Exchange Act of 1934, 48 Stat. 881 (1934); *see also* STEINBERG, *supra* note 188, at 1.

[191] *See* STEINBERG, *supra* note 188, at 1–2.

[192] *See* HANDBOOK OF ACCOUNTING AND AUDITING, *supra* note 27, at 5-3.

[193] *See* Securities Act of 1933 § 11.

file a registration statement with the SEC[194] that discloses certain information to potential investors—including financial data.[195] If the registration statement contains material misstatements or omissions, Section 11 permits those who purchased securities in the initial offering to sue the issuer's board of directors for all related losses.[196] The directors may also face criminal charges if they *willfully* allowed the material misstatements or omissions to occur.[197]

While investors may sue the board collectively, courts apportion any civil liability according to the responsibility of each individual director.[198] As a result, audit committee members remain especially vulnerable to Section 11 claims resulting from inaccurate financial statements. However, directors defending a Section 11 claim may assert several affirmative defenses. Specifically, evidence that a plaintiff securities purchaser possessed knowledge of the relevant misstatements or omissions at the time of sale will defeat a Section 11 claim.[199] Individual directors may also establish that they performed sufficient due diligence to negate any responsibility for the misstatements or omissions.[200]

The most significant source of potential audit committee liability under the Exchange Act stems from Section 10(b)[201]—the general securities fraud prohibition.[202] Section 10(b) empowers the SEC to promul-

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[194] *See id.* § 5.

[195] *See* 17 C.F.R. § 230.404(a) (2008).

[196] *See* Securities Act of 1933 § 11(a). Section 11 plaintiffs generally need not prove reliance on registration misstatements or omissions. *See* STEINBERG, *supra* note 188, at 148. *But see id.* (noting that Section 11 claimants must demonstrate reliance if they purchased the securities in question "more than 12 months after the effective date of the registration statement and if the issuer has made generally available an earnings statement covering this 12-month period.") (citing Securities Act of 1933 § 11(a)). Additionally, Section 11 plaintiffs need not demonstrate registration misstatements or omissions actually caused the loss in question. *See* STEINBERG, *supra* note 188, at 148.

[197] *See* Securities Act of 1933 § 24. Section 24 of the 1933 Act makes a willful violation of any provision in the 1933 Act a federal crime punishable by up to five years in prison and $5,000 in fines. *See id.*

[198] *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 758 (1995).

[199] *See id.*

[200] *See* Securities Act of 1933 § 11(b)(3). With respect to any misstatement or omission in a portion of the registration statement not based upon the opinion of an expert, defendant directors who are not experts must demonstrate that after performing a reasonable investigation, they had reason to believe—and in fact did believe—there was no material misstatement or omission. *See id.* With respect to any misstatement or omission in a portion of the registration statement based upon the opinion of an expert, defendant directors who are not experts must demonstrate that they had no reasonable ground to believe—and in fact did not believe—there was a material misstatement or omission. *See id.* If a portion of the registration statement is based upon the opinion of directors who are experts, those directors must demonstrate that after reasonable investigation, they had reason to believe—and in fact did believe—there was no material misstatement or omission. *See id.*

[201] *See* Securities and Exchange Act of 1934, § 10(b), 48 Stat. 881, 891 (1934).

[202] *See* STEINBERG, *supra* note 188, at 181.

gate rules prohibiting the use of "manipulative and deceptive device[s]" designed to defraud investors "in connection with the purchase or sale of any security registered on a national securities exchange."[203] The SEC thus promulgated Exchange Act Rule 10b-5 (Rule 10b-5), which prohibits individuals from employing any scheme or making any material misstatement or omission that perpetrates a fraud upon investors with respect to the purchase or sale of securities.[204] While the text of Section 10(b) does not explicitly provide for a private right of action against individuals who commit securities fraud, the Supreme Court has established an implied right of action that gives rise to civil liability.[205] Furthermore, acts of securities fraud committed in *willful* violation of Section 10(b) and Rule 10b-5 give rise to criminal liability as well.[206]

To succeed on a securities fraud claim based upon Section 10(b) and Rule 10b-5, investors must establish the existence of a materially false or misleading statement or an omission of fact connected with transactions in which they either purchased or sold securities.[207] Furthermore, investors must demonstrate that any directors named as defendants permitted the material misstatement or omission with scienter—intent to deceive.[208] A majority of courts, however, will infer scienter upon a showing that directors acted recklessly or were grossly negligent while fulfilling their responsibilities.[209] This willingness to infer scienter particularly burdens the audit committee, as members may face liability for recklessly failing to catch material misstatements or omissions generated by others in the financial reporting process. Additionally, investors pursuing a securities fraud claim must demonstrate reasonable reliance on the material misstatement or omission in question, but reliance on the securities' market price at the time of sale is typically sufficient to meet

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203 *See* Securities and Exchange Act of 1934 §10(b).

204 *See* 17 C.F.R. § 240.10b-5 (2008). The sale or purchase must involve some channel of interstate commerce, the mail, or a national securities exchange. *See id.* Transactions dealing in the shares of a public corporation generally meet this requirement with ease. *See* STEINBERG, *supra* note 188, at 182.

205 *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of th[e] implied remedy [under Section 10(b)] is simply beyond peradventure.").

206 *See* Securities and Exchange Act of 1934 § 10(b). Section 32 of the 1934 Act makes a willful violation of any provision in the 1934 Act a federal crime punishable by up to two years in prison and $10,000 in fines. *See id.* § 32.

207 *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988). A misstatement or omission of fact is material if a reasonable individual would have considered the omitted information important in making an investment decision. *See id.* The purchase or sale must also involve the channels of interstate commerce, the mail, or a national securities exchange—but this requirement is typically met when dealing with the securities of public corporations. *See* STEINBERG, *supra* note 188, at 182.

208 *See* Aaron v. SEC, 446 U.S. 680, 695 (1980) (finding scienter a necessary element for a violation of Exchange Act Rule 10b-5).

209 STEINBERG, *supra* note 188, at 187.

this burden.[210] Finally, investors pursing a securities fraud claim must establish that the material misstatement or omission caused them to suffer an actual loss.[211]

B. The Intrusion of Sarbanes-Oxley: Section 804 Statute of Limitations

Section 804 of the Sarbanes-Oxley Act provides a new statute of limitations for all "private right[s] of action that involve[ ] a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws."[212] Commentators, however, frequently criticize the language of Section 804 "as hastily passed and 'poorly crafted'" because it creates interpretational difficulties in defining the precise securities claims to which it refers.[213] Despite this lack of statutory precision, courts typically agree that the statute of limitations set forth in Section 804 applies to all claims of securities fraud under Section 10(b) and Rule 10b-5, but it does not apply to Section 11 claims.[214] The majority view reasons that the statutory language does not refer to Section 11 claims—even if such claims sound in fraud—because fraudulent intent is not an essential element of a claim brought under Section 11.[215]

Section 804 now permits plaintiffs to bring claims of securities fraud within two years of discovering the conduct that gave rise to the cause of action *or* within five years of the date such conduct took place.[216] The Sarbanes-Oxley Act thus extended the previous, more restrictive statutory period, which forced plaintiffs to bring securities fraud

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[210] *See Basic*, 485 U.S. at 247 (stating in plurality opinion that investors who rely on a security's market price at the time of sale are presumed to reasonably rely on any material misstatements or omissions for purpose of Rule 10b-5 actions); ALLEN ET AL., *supra* note 26, at 698 (noting that lower courts follow the plurality holding in *Basic* even though it does not constitute binding precedent on the Supreme Court).

[211] *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105(b), 109 Stat. 737, 757 (1995).

[212] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 804(b), 116 Stat. 745, 801 (2002).

[213] *In re* Enron Co. Sec., Derivative & ERISA Litig., No. MDL-1446, 2004 WL 405886, at *11 (S.D. Tex. Feb. 25, 2004) (quoting Bruce Vanyo, et al., *The Sarbanes-Oxley Act of 2002: A Securities Litigation Perspective*, 1332 PLI/CORP. 89, 119–20 (2002)); *see also* Michael A. Perino, *Statute of Limitations Under the Newly Passed Sarbanes-Oxley Act*, N.Y.L.J., Aug. 2, 2002, at 4 ("[The language of Section 804] is poorly drafted . . . [and] inconsistent with express statutes of limitation already contained in the federal securities laws and is likely to create significant interpretational difficulties for courts.").

[214] *See In re Enron*, 2004 WL 405886 at *12; *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 439–43 (S.D.N.Y. 2003); *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003); Friedman v. Rayovac Co., 295 F. Supp. 2d 957, 978–79 (W.D. Wis. 2003).

[215] *See In re Enron*, 2004 WL 405886 at *12.

[216] Sarbanes-Oxley Act § 804(a).

claims within one year of discovering the conduct that gave rise to the cause of action *and* within three years of the date such conduct took place.[217] Specifically, the longer statute of limitations prescribed in Section 804 applies "to all [securities fraud] proceedings . . . that are commenced on or after the date of enactment of [the Sarbanes-Oxley] Act."[218]

The statutory language implementing the extended limitations period gives rise to interesting questions regarding retroactive effect. By its own terms, Section 804 seems to revive securities fraud claims that had already expired by the time Congress enacted the Sarbanes-Oxley Act, but which still fall within the extended statute of limitations. This outcome is especially perplexing given the final clause in Section 804(c) prescribing that the extended statute of limitations "shall create [no] new, private right of action."[219]

C. *Retroactivity Doctrine*

Traditionally, Anglo-American law has viewed with hostility those legislative endeavors that seek to impose liability on actions that have already taken place.[220] Courts typically adhere to the maxim that "where no law is, there can be no transgression" despite the enactment of *post hoc* legislation imposing civil or criminal liability.[221] Moreover, the disfavor with which courts view laws that seek to impose liability on past conduct speaks to the very legitimacy of our legal system, as "[t]he nature of the rule of law is to substitute rules announced in advance for the [*post hoc* vigilante] judgment of men."[222] Three arguments support a cautious treatment of such legislation. First, fundamental fairness and the establishment of social order necessitate reliance upon current law[223]—individual actors often evaluate the legal ramifications of a particular course before taking any action. Second, the power to impose liability *post hoc* increases the ability of the political majority to discriminate against unpopular groups within the political minority.[224] Bias, for example, may tempt lawmakers looking backward to enact discriminatory legislation because "[a] law for the future is impersonal; whereas a

[217] *See* 15 U.S.C. § 78i(e) (2007).

[218] Sarbanes-Oxley Act § 804(b).

[219] Sarbanes-Oxley Act § 804(c).

[220] *See, e.g.*, DANIEL E. TROY, RETROACTIVE LEGISLATION 1 (1998); Elmer E. Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisdiction*, 20 MINN. L. REV. 775, 775 (1936).

[221] *See Romans* 5:13 ("[S]in is not imputed when there is no law.").

[222] TROY, *supra* note 220, at 19.

[223] *See* W. David Slawson, *Constitutional and Legislative Considerations in Retroactive Lawmaking*, 48 CAL. L. REV. 216, 222 (1960).

[224] *See* TROY, *supra* note 220, at 19.

law for the past may be personal."[225] Third, widespread adoption of backward-operating legislation results in an inefficient allocation of economic resources,[226] as uncertainty stemming from the legal system provides a powerful incentive for firms to under-invest.[227]

Hostility to legislation that disrupts prior reliance on the law lives in several sections of the Constitution. Article I, Section IX provides that Congress shall pass "[n]o Bill of Attainder or ex post facto law."[228] In addition, Article I, Section X prescribes that "[n]o state shall . . . pass any ex post facto Law."[229] These provisions prevent the federal and state governments from enacting legislation that criminalizes conduct that has already occurred.[230] Additionally, the Contracts Clause prevents the passage of any law "impairing the Obligation of Contracts" already in force,[231] and the Takings Clause prescribes that "private property [shall not] be taken for public use, without just compensation."[232] The Due Process Clauses of the Fifth[233] and Fourteenth[234] Amendments also prevent the federal and state governments from depriving any individual of "life, liberty, or property without due process of law." However, the Takings and Due Process Clauses do not completely prohibit backward-operating legislation.[235] Both the state and federal governments thus retain some flexibility under the Constitution to infringe upon expectations crafted in reliance upon the law.[236]

All laws displace the prior expectations of individuals to a certain extent,[237] as the implementation of most legislation depends upon antecedent facts.[238] Lawmakers first observe conduct or circumstances considered sub-optimal from a societal perspective, and then enact legislation that uses criminal or civil liability to alter behavior.[239] At the very least, individuals who act in reliance upon existing legal rules will be surprised when those rules change.[240] Legal change, however, be-

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225 Bryant Smith, *Retroactive Laws and Vested Rights*, 6 TEX. L. REV. 409, 417 (1928).

226 *See* TROY, *supra* note 220, at 20–21.

227 *See* Pablo T. Spiller, *Institutions and Regulatory Commitment in Utilities' Privatization*, 2 IND. CORP. & CHANGE 387, 393 (1993) (documenting the adverse economic effects of legal instability in developing countries).

228 U.S. CONST. art. I, § 9.

229 U.S. CONST. art. I, § 10.

230 *See* Calder v. Bull, 3 U.S. 365 (1798).

231 U.S. CONST. art. I, § 10.

232 U.S. CONST. amend. V.

233 *Id.*

234 U.S. CONST. amend. XIV.

235 *See* NOWAK & ROTUNDA, *supra* note 134, § 11.9, § 11.11.

236 *See* TROY, *supra* note 220, at 4.

237 *See id.* at 2.

238 *See id.*

239 *See id.*

240 *See id.*

comes necessary with the evolution of society. As a result, an appropriate balance must be struck because "[i]f every time a man relied on existing law in arranging his affairs, he were made secure against any change in legal rules, the whole body of our law would be ossified forever."[241]

The retroactivity doctrine seeks to balance the need for legal change with the importance of protecting legitimate expectations formulated in reliance upon the law. The doctrine determines when legislation has a sufficiently significant effect on past expectations to be deemed "retroactive."[242] The doctrine then dictates which retroactive enactments are illegitimate.[243] A retroactive statute "takes away or impairs vested rights acquired under existing laws, or creates a new obligation, imposes a new duty, or attaches a new disability, in respect to transactions or considerations already past."[244] Thus, a retroactive statute changes the legal consequences of conduct that has already taken place.[245] Strong retroactive legislation explicitly states that it applies only to conduct that took place before the date of its enactment.[246] Weak retroactive legislation operates in a forward manner, but it also explicitly changes the legal consequences of past behavior.[247] Finally, implied retroactive legislation makes no mention of past behavior but nonetheless changes the legal consequences of actions that have already occurred.[248]

Since "the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place,"[249] the Supreme Court has adopted a presumption against retroactivity.[250] The Court set forth a two-prong test in *Landgraf v. USI Film Products* for determining when federal statutes overcome the presumption and constitutionally operate upon prior actions.[251] First, courts must determine whether any evidence exists that demonstrates explicit, unambiguous congressional intent to apply the statute retroactively.[252] Such a determination requires both an investigation of the statutory text and the relevant legislative his-

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241 LON L. FULLER, THE MORALITY OF LAW 60 (1964).

242 *See* TROY, *supra* note 220, at 2–3.

243 *See id.*

244 Landgraf v. USE Film Products, 511 U.S. 244, 269 (1994) (quoting Soc'y for Propagation of the Gospel v. Wheeler, 22 F. Cas. 756, 767 (1814) (Story, J.)).

245 *See* TROY, *supra* note 220, at 6.

246 *See* Stephen R. Munzer, *Retroactive Law*, 6 J. LEGAL STUD. 373, 383 (1977).

247 *See* TROY, *supra* note 220, at 6.

248 *See id.* at 7.

249 *Landgraf*, 511 U.S. at 266 (Scalia, J., concurring) (quoting Kaiser Aluminum & Chem. Corp. v. Bonjorno, 494 U.S. 827, 855 (1990) (Scalia, J., concurring)).

250 *See id.* at 265 (citing *Kaiser Aluminum & Chem. Corp.*, 494 U.S. at 855 (discussing Supreme Court decisions evidencing a strong presumption against retroactivity)).

251 *See id.* at 268.

252 *See id.*

tory.[253] Provided the enactment is otherwise constitutional, courts must comply with explicit, unambiguous congressional intent to retroactively apply legislation.[254] Second, in the absence of explicit, unambiguous congressional intent, courts must determine whether the legislation in question sufficiently disrupts past expectations such that it has "retroactive effect."[255] If the legislation operates retroactively in the absence of congressional intent, it must be struck down.[256]

D. *Current Interpretations of Sarbanes-Oxley Section 804*

1. *In re Enterprise Mortgage Acceptance Co. Securities Litigation*

In *Enterprise*, the Second Circuit articulated the majority position with respect to the impact of Section 804 on stale securities fraud claims.[257] The plaintiffs asserted securities fraud claims under Section 10(b) and Rule 10b-5 that were time-barred under the applicable statute of limitations in place before the enactment of the Sarbanes-Oxley Act but which fell within the longer window set forth in Section 804.[258] The district court dismissed the case on the ground that Section 804 does not revive stale claims.[259] On appeal, the Second Circuit applied the Supreme Court's two-prong retroactivity test from *Landgraf*.[260]

Under the first prong of the *Landgraf* test, courts must comply with any explicit, unambiguous congressional intent to apply a statute retroactively.[261] Judge Cabranes began the inquiry with an evaluation of the Section 804(b) language stating that the longer statute of limitations "shall apply to all [securities fraud] proceedings . . . that are commenced on or after the date of enactment of [the Sarbanes-Oxley] Act."[262] The plaintiffs argued that this language demonstrates clear intent to apply the longer statute of limitations in all securities fraud claims brought after the enactment of the Sarbanes-Oxley Act—regardless of whether the

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253 *See id.*

254 *See id.* at 280.

255 *See id.*

256 *See id.*

257 *See In re* Enterprise Mortgage Acceptance Co. Sec. Litig., 391 F.3d 401, 410 (2d Cir. 2005). The Third, Fourth, Fifth, Seventh, and Eighth Circuits subsequently concurred with the *Enterprise* analysis. *See* Margolies v. Deason, 464 F.3d 547, 551 (5th Cir. 2006); Lieberman v. Cambridge Partners L.L.C., 432 F.3d 482, 484 (3d Cir. 2006); *In re* ADC Telecomm., Inc. Sec. Litig., 409 F.3d 974, 977 (8th Cir. 2005); Glaser v. Enzo Biochem, Inc., No. 03-2188, 2005 WL 647745, at *4 (4th Cir. 2005); Foss v. Bear, 394 F.3d 540, 542 (7th Cir. 2005).

258 *See Enterprise*, 391 F.3d at 404.

259 *See id.*

260 *See id.* at 405–10.

261 *See Landgraf*, 511 U.S. at 268.

262 *Enterprise*, 391 F.3d at 406.

claims were previously time-barred.[263] Judge Cabranes opined, however, that although Section 804(b) is "most naturally read" according to the plaintiffs' interpretation, the language is in fact ambiguous with respect to congressional intent.[264] First, he noted that Section 804(b) does not contain the exact language the Supreme Court determined would constitute unambiguous evidence of intent in *Landgraf*.[265] Moreover, Judge Cabranes pointed to the Section 804(c) language stating that "[n]othing in this section shall create a new, private right of action."[266] He reasoned that empowering a plaintiff to bring a claim that was previously time-barred—and thus had no legal basis—could reasonably be construed as creating a new cause of action.[267] Since the explicit language of Section 804 was ambiguous, it failed the first prong of the *Landgraf* test.[268]

The second prong of the *Landgraf* test dictates that in the absence of explicit evidence of congressional intent, courts must strike down legislation to the extent it operates retroactively.[269] Judge Cabranes reasoned that extending a statute of limitations *post hoc* sufficiently disrupts expectations so as to generate a retroactive effect because it 'increase[s] [a defendant's] liability for past conduct.'[270] Extending a statute of limitations to revive stale claims increases the amount of time during which potential defendants may face suit and deprives them of an affirmative defense upon which they may have reasonably relied.[271]

2. *Tello v. Dean Witter Reynolds, Inc.*

In *Dean Witter Reynolds*, the Eleventh Circuit articulated the minority position with respect to the impact of Section 804 on stale claims.[272] The plaintiffs asserted securities fraud claims under Section 10(b) and Rule 10b-5 that were time-barred under the applicable statute of limitations in place before the enactment of the Sarbanes-Oxley Act but which

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263 *See id.* at 406.

264 *See id.* at 406–07.

265 *See id.* at 406. In *Landgraf*, the Supreme Court determined that the language "all proceedings pending on or commenced after the date of enactment" provided unambiguously explicit evidence of Congress's intent regarding retroactive application. *Landgraf*, 511 U.S. at 255–56 n.8. Section 804 does not include the phrase "pending on" as used in *Landgraf*. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 804, 116 Stat. 745, 801 (2002)

266 *Enterprise*, 391 F.3d at 407.

267 *See id.*

268 *See id.*

269 *See Landgraf*, 511 U.S. at 280.

270 *Enterprise*, 391 F.3d at 410 (quoting *Landgraf*, 511 U.S. at 280).

271 *See id.*

272 *See* Tello v. Dean Witter Reynolds, Inc., 410 F.3d 1275, 1286 (11th Cir. 2005). The Second, Third, Fourth, Fifth, Seventh, and Eighth Circuits have each adopted the opposing position. *See supra* note 257 and accompanying text.

fell within the longer window set forth in Section 804.[273] On interlocutory appeal from the district court, the Eleventh Circuit applied the Supreme Court's two-prong retroactivity test from *Landgraf*.[274]

Under the first prong of the *Landgraf* test, the court began with an evaluation of the Section 804(b) language stating that the longer statute of limitations "shall apply to all [securities fraud] proceedings . . . that are commenced on or after the date of enactment of . . . [the Sarbanes-Oxley] Act."[275] Unlike Judge Cabranes in *Enterprise,* Judge Birch of the Eleventh Circuit looked only to the most reasonable interpretation of the text, which suggests a retroactive application.[276] He reasoned that because the longer statute of limitations applies to all securities fraud claims brought after the enactment of the Sarbanes-Oxley Act, it necessarily applies to claims that were previously time-barred.[277] Judge Birch gave no weight to the Section 804(c) language stating that the extended statute of limitations fails to create new private rights of action.[278] As a result, the Eleventh Circuit held that the Section 804 text evidenced explicit, unambiguous congressional intent to apply the longer statute of limitations retroactively.[279] Since the first prong of the *Landgraf* test was met, the analysis ended and the court applied the extended statute of limitations retroactively.[280]

E. Analysis: Sarbanes-Oxley Section 804 Interpretations

The Eleventh Circuit erred in failing to consider the language of Section 804(c) under the first prong of the *Landgraf* test. While Judge Birch correctly concluded the most reasonable interpretation of Section 804(b) suggests application of the longer statute of limitations to previously time-barred claims, the first prong of the *Landgraf* test requires "unambiguous" evidence of congressional intent[281]—not evidence of a statute's most reasonable interpretation. The intent of Congress may remain ambiguous with respect to a piece of legislation even if most reasonable individuals would interpret the statutory language in a certain way.[282] Since Section 804(c) provides that the extended statute of limi-

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273 *See Dean Witter Reynolds*, 410 F.3d at 1277.

274 *See id.* at 1278, 1281–83.

275 *Id.* at 1279.

276 *See id.* at 1279–83.

277 *See id.* at 1279, 1282.

278 *See id.* at 1279–83.

279 *See id.* at 1281–82.

280 *See id.*

281 Landgraf v. USE Film Products, 511 U.S. 244, 263 (1994).

282 *See In re* Enterprise Mortgage Acceptance Co. Sec. Litig., 391 F.3d 401, 407 (2d Cir. 2005).

tations does not give rise to any new private rights of action,[283] the text of the Sarbanes-Oxley Act leaves some doubt as to whether Congress intended the new limitations period to revive securities fraud claims that were previously time-barred.

Nevertheless, as demonstrated in the SEC's amicus brief,[284] the Second Circuit failed to sufficiently consider the legislative history of Section 804 under the first prong of the *Landgraf* test. Judge Cabranes noted that nothing in the legislative history "indicates that the extension of the statute of limitations was intended to revive expired claims or that Congress was even considering such a thing."[285] Senator Patrick Leahy, however, specifically introduced Section 804 because the prior statute of limitations prevented certain Enron investors from pursuing securities fraud claims against the corporation and its directors.[286] As such, Congress extended the statute of limitations for securities fraud to provide victims of then recently discovered accounting scandals with a means of bringing judicial actions that were time-barred under existing law.[287] Section 804 therefore "applies to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred."[288] Furthermore, Section 804(c) merely serves to clarify that the extended statute of limitations only applies to "already existing private causes of action under the various federal securities laws that have been held to support private causes of action."[289] Section 804(c) does not speak to retroactivity, as it simply dictates the *type* of claim in which plaintiffs may invoke the extended limitations period.[290] Since Section

283 Sarbanes-Oxley Act of 2002, Pub. L. No. 107–294, § 804(c), 116 Stat. 745, 801 (2002).

284 *See* Brief of the Securities and Exchange Commission Amicus Curiae Supporting Respondents, AIG Asian Infrastructure Fund, L.P. v. Chase Manhattan Asia Ltd., No. 04-2403, 2005 WL 435406 (2005). The SEC first proffered the legislative history argument for Section 804's retroactive application in an amicus brief prior to *AIG Asian Infrastructure Fund, L.P. v. Chase Manhattan Asia Ltd. See id.* The court in *Enterprise* took judicial notice of this amicus brief, but it imprudently dismissed the SEC's superior argument because the agency lacked legal authority to enforce its position. *See Enterprise*, 391 F.3d at 410 n.8.

285 *Enterprise*, 391 F.3d at 408.

286 *See* 148 CONG. REC. S1785–86 (2002) (statement of Sen. Leahy).

287 *See, e.g.*, 148 CONG. REC. S6524–02, S6534 (2002) (statement of Sen. Leahy) ("We already have a very short statute of limitations in here anyway. We ought to at least have [it so] that . . . people might be able to recover some of the money they have lost . . . . There ought to be some way for the people who lost their pension, lost their li[f]e savings, to get it back."); *id.* at S6540–41 (statement of Sen. Leahy) ("[W]e see WorldCom and Tyco and Xerox, and we say . . . let's do everything we can to let the people defrauded by them recover some of their ill-gotten gains."); 148 CONG. REC. H4683–01, H4692 (2002) (statement of Rep. Markey) ("We are only finding out right now about fraud from 2 or 3 years ago. We need to stretch out the statute of limitations so [the victims] can sue.").

288 148 CONG. REC. S7418 (2002) (statement of Sen. Leahy).

289 *Id.*

290 *See id.*

804 passes the first prong of the *Landgraf* test, courts should end the analysis and apply the extended statute of limitations retroactively.[291]

Nevertheless, even if a court proceeds to the second prong of the *Landgraf* test, several important issues still arise. Judge Cabranes correctly reasoned that extending a statute of limitations to revive stale claims deprives defendants of an affirmative defense upon which they may have reasonably relied.[292] As a result, interpreting Section 804 to revive previously time-barred securities fraud claims seems to unfairly disrupt prior expectations. The presumption against retroactive legislation, however, fundamentally assumes that individuals modify their behavior depending upon the current state of law.[293] It appears unlikely that corporate managers evaluate the applicable statute of limitations for securities fraud in deciding whether or not to engage in deceitful activity. While directors and officers may consider the probability of being caught perpetuating a fraud, it seems doubtful they reflect upon the length of time during which aggrieved investors could bring suit. As a result, the second prong of the *Landgraf* test may simply be inadequate to deal with the retroactive application of Section 804.

F. Analysis: Sarbanes-Oxley, Federal Securities Legislation, and the Audit Committee

While the Sarbanes-Oxley Act affects the audit committee in a number of important ways, it fails to significantly alter the federal liability *standards* that govern individual audit committee members. For example, the Sarbanes-Oxley Act codifies the many specific duties of an audit committee through amendment of the Exchange Act.[294] Nevertheless, its provisions fail to reach the liability *standards* set forth under Securities Act Section 11 and Exchange Act Rule 10b-5.[295] Although Section 804 of the Sarbanes-Oxley Act extends the statute of limitations for securities fraud, it fails to alter the *standards* by which courts in search of liability review the conduct of directors. Thus, even if the Supreme Court intervenes to grant Section 804 retroactive effect, individual audit committee members who served during the accounting scandals of the late 1990's would not face more exacting scrutiny of their conduct.

Additionally, the Sarbanes-Oxley Act extends the criminal liability standards set forth under federal securities legislation only to a limited

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[291] Landgraf v. USE Film Products, 511 U.S. 244, 280 (1994).

[292] *In re* Enterprise Mortgage Acceptance Co. Sec. Litig., 391 F.3d 401, 407 (2d Cir. 2005).

[293] *See* TROY, *supra* note 220, at 18 ("The requirement that people be given notice of the legal implications of their behavior assumes that . . . we are capable not only theoretically of modifying our behavior depending on the rule of law, but that we do so in fact.").

[294] *See supra* Part I.A.

[295] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).

extent. Section 802, for example, creates new criminal liability for the destruction or alteration of documents with intent to hinder a federal investigation.[296] The Sarbanes-Oxley Act also increases the criminal penalty for certain white collar federal crimes[297]—including securities fraud.[298] However, the federal securities laws have always prescribed that any willful violation of their provisions constitutes a criminal offense.[299] Thus, while audit committee members may face greater *exposure* to criminal liability because of the many responsibilities the Sarbanes-Oxley Act imposes upon them, courts still review individual abdications of those responsibilities under the historical *standard*—only willful abdications give rise to criminal liability.

CONCLUSION

In response to the accounting fraud that infiltrated U.S. capital markets at the dawn of the new millennium, the Sarbanes-Oxley Act imposed a set of responsibilities upon audit committees that dramatically increased the burden of their membership.[300] The enactment, however, fails to significantly heighten the liability standards governing audit committee members under both state corporate law and federal securities legislation.[301] For example, perhaps the greatest increase in liability exposure that audit committee members face stems from the potential for willing or knowing abdications of the numerous responsibilities the Sarbanes-Oxley Act imposes upon them.[302] However, the criminal liability associated with any willful abdication remains a traditional aspect of federal securities legislation,[303] and the civil liability associated with any knowing abdication remains a traditional aspect of state corporate law.[304] The Sarbanes-Oxley Act thus increases liability *exposure*, but it fails to significantly heighten the *standards* under which the law scrutinizes audit committee members' conduct.

While audit committee members may take some comfort in knowing "'liability [standards have] changed very little,'"[305] they must still remain cognizant that "'the emotional perception of liability has changed a [great deal].'"[306] Much of the public hostility towards corporate direc-

296 *See id.* § 802.
297 *See id.* Title IX.
298 *See id.* § 807.
299 *See* Securities Act of 1933, § 24, 48 Stat. 74, 87 (1933); Securities and Exchange Act of 1934, § 32, 48 Stat. 881, 904 (1934).
300 *See supra* notes 10–22 and accompanying text and Part I.A.
301 *See supra* Part II.D and Part III.F.
302 *See supra* note 181 and accompanying text and Part III.F.
303 *See supra* note 299 and accompanying text.
304 *See supra* note 181 and accompanying text.
305 STUART, *supra* note 6, at 17.
306 *Id.*

tors that arose in the wake of Enron's collapse has yet to dissipate.[307] As a result, a given judge or jury might readily indulge the inclination to stretch liability standards with respect to the audit committee—particularly when a case involves financial misstatements or omissions. Even though the Sarbanes-Oxley Act fails to significantly alter the black letter law articulating these standards, it seems that individual audit committee members will have to continue "'walking a fine line between "reasonable care" and "unreasonable worry"'" well into the foreseeable future.[308]

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[307] *See id.*
[308] *Id. at* 16.