INSIGHTS

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Company Liability after the Sarbanes-Oxley Act

Companies have always been exposed to liability when senior officers allegedly commit fraud. Now, the Sarbanes-Oxley Act requires senior officers to sign certifications attesting to the adequacy of disclosure controls and reporting changes and significant deficiencies in internal control. It is no surprise that false certification claims are now creeping into securities fraud complaints, potentially exposing companies to liability for a wider range of alleged misconduct.

by Peri Nielsen and Claudia Main

According to a recent KPMG survey, approximately 40 percent of corporate fraud involves employees in the finance department.[1] The primary reason: A weak control environment. In almost 70 percent of the cases surveyed, there was no publicity surrounding the investigation or subsequent sanction. In other words, shareholders never learned about it. This ignorance is now changing in the wake of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Sarbanes-Oxley requires senior officers to attest to the effectiveness of their companies' disclosure controls and procedures. It also requires officers to certify that certain disclosures have been made, including material changes in internal control and "any" fraud involving employees who have a significant role in internal control over financial reporting. As a result, more and more companies are now disclosing significant deficiencies in their controls environments, including poor documentation and "lack of compliance" with policies and procedures by lower level employees. Some of these companies have had to restate their financial results as a result.

While the ramifications of this disclosure on private securities litigation are far from clear, one thing is certain: Class action plaintiffs are starting to include allegations of false certifications in their complaints. While weak or inadequate internal controls allegations are hardly new to securities litigation, their revival is strengthened by the fact that the certification requirements provide some link between a signing officer's knowledge and allegedly inadequate or ineffective procedures. The required disclosures also offer private plaintiffs a means of finding confidential witnesses to corroborate their assertions with anecdotal tales of sloppy recordkeeping and lack of checks and balances in accounting. Whether and to what extent courts will entertain these allegations is still unknown. The certification requirements, however, potentially broaden the scope of misconduct for which the corporation is potentially liable in securities litigation.

This article examines the common law and statutory theories for imposing liability on companies in private litigation. It also analyzes the Sarbanes-Oxley certification requirements and their potential impact on companies defending such litigation.

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Traditional Theories for Imposing Corporate Liability

Section 10(b) requires that plaintiffs plead and prove that the defendant possessed the required state of mind to commit securities fraud. Companies do not have states of mind. Thus, the question of when a company can be held liable for fraud requires the application of legal theories. These theories include traditional agency principles, statutory "control person" liability, and even "collective" *scienter*, *i.e.*, that a company possesses the collective state of mind of all employees. Although some corporate defendants have tried to limit the application of these theories, courts have generally rejected any kind of limitation for fear of depriving plaintiffs of what might be the only "deep pocket" source of recovery.[2]

Common Law Vicarious Liability

A company is generally responsible for the acts of its agents under common law.[3] There are three agency principles: (1) if the company "actually" authorized the tortious conduct of the agent; (2) if it appears that the agent has "apparent authority" to commit the tortious conduct; and (3) if the agent has "inherent agency powers," commonly known as the doctrine of *respondeat superior*.[4] Because companies rarely actually authorize their employees to commit securities fraud, the latter two principles are more pertinent to securities litigation. Courts have been split on which one to apply.

1. *Apparent Authority.* Some courts apply "apparent authority" because the agents who allegedly committed the fraud are ordinarily high level corporate officers (*e.g.*, CEO and CFO).[5] The company is held liable for the acts of such individuals because it placed them in a position to invoke the company's authority.[6] In addition, courts reason that imposing such liability on the company would encourage corporate officials to prevent unauthorized misrepresentations.[7]

2. *Inherent Agency Powers.* Other courts apply the doctrine of *respondeat superior* in the securities fraud context. Under this doctrine, the fraud of an employee is imputed to the company as long as the employee committed the fraud in the scope of his or her employment.[8]

The *respondeat superior* doctrine is a form of strict liability.[9] It does not permit an examination of the company's conduct, including whether it was duly diligent in enforcing reasonable procedures to prevent the illicit conduct. It merely looks to the employee's status to hold the company responsible. One court reasoned that this "non-authority" based vicarious liability is premised on important social and commercial policies, such as "stimulat[ing] the watchfulness of the employer in selecting and supervising the agents."[10]

The Ninth Circuit's decision in *Hollinger* is frequently cited for invoking the *respondeat superior* doctrine in private securities litigation. The *Hollinger* plaintiffs were investors seeking to recover funds embezzled by their securities broker. The broker had been convicted of forgery 11 years before he was registered as a salesperson with the National Association of Securities Dealers, Inc. (NASD). The NASD regulation did not require disclosure of the conviction, and the conviction did not disqualify the broker from being licensed to work as a salesperson in the securities industry. The plaintiffs sued the broker's brokerage firm (Titan) for failing to disclose the forgery conviction to the investors.

The Ninth Circuit agreed with the lower court that Titan was not reckless in failing to disclose the conviction and, therefore, could not be primarily liable under Section 10(b). The Ninth Circuit, however, found that Titan could be held liable for the broker's conduct under the doctrine of *respondeat superior*, as well as under "control person" liability. The court found that Congress did not intend to protect unsophisticated investors by allowing brokerage firms "'to avoid secondary liability simply by showing ignorance, purposeful or negligent, of the acts of the registered representative.'"[11]

3. *Adverse Interest Exception.* Although *respondeat superior* is a form of corporate strict liability, some defendants have argued that the "adverse interest exception" can eliminate corporate liability for the actions of an agent where the agent acted "adversely" to the company's interests.[12]

The Ninth Circuit's decision in *FDIC v. O'Melveny & Meyers* is frequently cited for the "adverse interest exception." In *FDIC*, the Ninth Circuit considered

whether the FDIC, which stood in the shoes of a failed savings and loan (S&L), could assert malpractice claims against the S&L's attorneys. High ranking officers of the former S&L had been accused of intentionally and fraudulently overvaluing assets and entering into sham sales to boost profits.[13] The defendants argued that the conduct of the officers should be imputed to the S&L, thereby estopping the FDIC's claims.[14] The Ninth Circuit disagreed, finding that the "adverse agent" doctrine precluded attribution of the officers' wrongdoing to the corporation. The court stated:

> Generally the knowledge of a corporate officer within the scope of his employment is the knowledge of the corporation. However, the knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal.

The court found that "disaster, not benefit accrued to" the company as a result of the officers' malfeasance, but even if it did benefit, the "insiders' conduct is still not attributable to the corporation if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing."

Defendants have generally not been successful in invoking the "adverse interest exception" in securities litigation. One problem appears to be that courts are undecided whether employees who commit the wrongdoing are necessarily acting adversely to the company. In the *Cylink* securities litigation, for example, plaintiffs alleged that Cylink, as well as its CEO, CFO, and VP of Sales, were primarily liable under Section 10(b). The defendants argued that plaintiffs could not plead a direct claim against Cylink based solely on the actions of the individual officers because they were acting adversely to the company's interests when they allegedly committed revenue recognition fraud. The court rejected this argument. In so doing, it observed, "misstatements disseminated to a securities market seldom, if ever, benefit the issuer of securities."[15] The court also observed "[i]f a misleading corporate dissemination benefits the issuer, then presumably its shareholders were benefited at least indirectly."[16] Similarly, in the *Rent-Way* securities litigation, the Western District of Pennsylvania declined to invoke the adverse interest exception where the controller and other accounting personnel allegedly falsified journal entries and engaged in other accounting improprieties. The court reasoned that, as alleged, the purported accounting fraud "was intended to benefit the company by permitting it to grow."[17]

It is questionable whether this reasoning has the same applicability after the passage of Sarbanes-Oxley. Now, the short-term ramifications of transgression are more apparent and predictable, mostly by virtue of the company's having to incur significant outside legal and accounting advisor fees to ferret out, disclose and rectify the wrongdoing. Individual officers and employees do not pay these fees. These fees are borne solely by the company, making the company's shareholders the principal "victims" of the wrongdoing. These costs are even more burdensome, and potentially devastating, for newer and smaller companies. It is hard to imagine any benefit to the corporation of employee misconduct in the face of these costs.

Statutory Secondary "Control Person" Liability

A company can also be held liable for the acts of its employees under the "control person" liability provisions of the securities laws. Sections 15 of the Securities Act of 1933 and Section 20 of the Securities Exchange Act of 1934 impose liability upon persons who "directly or indirectly" control persons who are liable for securities violations. The SEC defines "control" as "[t]he possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[18] Courts are split on whether the "control person" provisions were intended to supplant or supplement common law agency principles in the securities litigation context.

Courts generally agree that the SEC's definition of "control persons" encompasses a variety of corporate actors. Courts tend to diverge in defining the "requisite level of involvement in the primary violator's fraudulent conduct necessary to conclude the defendant was a controlling person under Section 20(a)."[19] Under the "control by status" approach, courts essentially assume an officer or director is a control person by virtue of his or her status in the corporation.[20] Other courts require more than a title, examining the individual's "culpable

participation" in the wrongful activity.[21] Between the "control by status" and "culpable participation" tests is the "power to control" approach, which imposes control person liability whether or not the officer was aware of or participated in the wrongful conduct.[22] Control persons are entitled to a "good faith" affirmative defense under the respective statutes.[23] Most courts hold that the defendant bears the burden of proving "good faith."[24]

The concept of evaluating and assessing a company's "internal control" as "control persons" comes into play in the broker-dealer context. In *Hollinger*, the Ninth Circuit concluded that the broker-dealer was a "control person" of the broker because it had the power to terminate the broker or impose conditions on his or her association with it. In addition, the court stated, "because the broker-dealer is required by statute to establish and enforce a reasonable system of supervision to control its representatives' activities, the broker-dealer necessarily exerts ongoing control over the types of transactions made by the representative and her ways of handling clients' accounts."[25]

The *Hollinger* court, however, stated that, by recognizing the control relationship, it did not intend to impose vicarious liability under Section 20(a) on a broker-dealer for *all* registered representatives' activities. The court pointed out that the good faith defense was intended "to avoid what [Congress] deemed to be an undesirable result, namely that of insurer's liability."[26] In proving "good faith," the court observed that a broker-dealer could not simply say it had supervisory procedures in place. It must show that it "maintained and enforced a reasonable and proper system of supervision and internal control."[27]

These days, securities class action plaintiffs do not ordinarily assert Section 20(a) claims against companies, presumably because plaintiffs may use common law agency principles to impute the primary violator's knowledge to the company. Plaintiffs mainly use Section 20(a) to reach individual officers, directors and shareholders who allegedly "control" the primary wrongdoer. Although this structure would appear to deprive the company of a "good faith" defense, it has little consequence as a practical matter at the pleading stage since plaintiffs must allege that the primary violator acted recklessly (a higher standard) before the company is exposed at all. If a case survives the pleading stage, however, the unavailability of a "good faith" defense appears to contravene Congress's concern about imposing "insurer's liability" on companies, particularly when it comes to internal control claims.

Courts are split on whether the "control person" provisions were intended to supplant or supplement common law agency principles in the securities litigation context.

Initially, there was some debate as to whether the "control person" liability provisions were intended to be the exclusive means of imposing liability on the corporation, *i.e.*, whether they were designed to "supplant" *respondeat superior*, rather than merely "supplement" it.[28]

The *Hollinger* court addressed this very question and declined to eliminate *respondeat superior* liability for securities fraud. The court reasoned that the proper construct for the securities laws was primary liability for the employee, *respondeat superior* liability for the employer, and then "control person" liability for anybody who could not be reached by *respondeat superior*.[29] The First Circuit court agreed, finding that Congress intended these provisions as "imposing liability on, say, a shareholder or a director who controlled a corporation engaged in misrepresentation, presumably including persons beyond the reach of ordinary common law agency principles."[30]

In 1994, the Supreme Court decided *Central Bank* and eliminated aiding and abetting as a form of Section 10(b) liability. After *Central Bank*, there was some expectation that *Hollinger*, as well as the practice of applying *respondeat superior* to secondary actors in general, would be called into question.[31] While some courts decided to limit secondary liability to statutory "control persons," most courts declined to eliminate *respondeat superior*, reasoning that the issue is not the scope of conduct proscribed by Section 10(b) but, rather, on whose shoulders to place responsibility for such conduct.[32]

Even those cases in which secondary liability has been limited to "control persons," courts express some

reservation about eliminating vicarious liability altogether. The Northern District of Indiana, for example, declined to impose *respondeat superior* liability on the brokerage firm when plaintiffs invested in an unprofitable partnership, at the recommendation of the firm's broker.[33] The court reasoned that Section 20(a) existed to avoid saddling those who lacked *scienter* with absolute vicarious liability. It stated, "Congress never intended employee supervision to entail total *monitoring* of salesmen's statements. Nor does any regulation of SEC or any exchange so require."[34] The court noted, however, that it might be "more appropriate to affix co-liability on a corporation for the protracted misdeeds of its chief executive officer than for the isolated action of one salesman. The necessary united identification of actor and employer is certainly more readily reached with respect to the corporation's Chief Executive Officer than such as the facts in the case before the Court."[35]

Courts express some reservation about eliminating vicarious liability altogether.

At least one court has also addressed whether *respondeat superior* should be eliminated in all types of securities fraud cases besides those arising in the broker-dealer context, thus limiting *Hollinger*. In *Network Equipment*, plaintiffs alleged that the company and several of its officers orchestrated a scheme to record improperly revenue on fictional sales to customers so they could profit by selling their stock at artificially high prices.[36] The defendants argued that *respondeat superior* liability would render the good faith defense under Section 20(a) irrelevant where the control person is also a principal or master of an agent wrongdoer. The defendants also argued that "respondeat superior liability establishes a form of secondary liability which does not require actual knowledge or recklessness on the part of the vicariously liable principal, and, as a result, conflicts with scienter requirement of Rule 10b-5."[37] The court did not analyze the substance of either of these arguments, finding instead that they would have applied equally to broker-dealers as to corporations and, therefore, were not valid bases for distinguishing the *Hollinger* holding.

Finally, a number of cases have considered the concept of "collective" *scienter* to impose primary liability on a corporation absent a specific individual's knowledge. The theory holds that a company can be primarily liable for securities fraud because it possesses the collective states of minds of all of its employees.[38] This theory has largely been rejected. As the Fifth Circuit put it, "the required state of mind must *actually* exist in the individual making (or being a cause of making of) the misrepresentation, and may not simply be imputed to that individual on general principles of agency."[39] Similarly, the Ninth Circuit recognized that "corporate *scienter* relies heavily on the awareness of the directors and officers, who—unlike the public relations or personnel departments—are necessarily aware of the requirements of SEC regulations and state law and of the 'danger of misleading buyers and sellers.'"[40]

Sarbanes-Oxley Certification Requirements

Sarbanes-Oxley has the potential to enliven the debate concerning the scope of corporate liability because it requires high-level officers (the CEO and CFO) to attest to the effectiveness of their companies' disclosure controls and procedures, as well as to disclose changes to control frameworks, significant deficiencies, material weaknesses and "any" fraud by employees who have a significant role in internal control over financial reporting.

Section 302 Certifications

Section 302 is a civil statute enforced by the SEC. It requires certifications by both the company's CEO and CFO (or Chief Accounting Officer).[41] The certification language cannot be modified.[42] The officers must state that they have "reviewed the report" and that based on "my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report."[43] The certification also requires the officer to state that, "based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report."[44]

In addition, the certification also requires officers

to certify that he or she "designed such disclosure controls and procedures . . . to ensure that material information relating to the registrant" is known to them. The term "disclosure controls and procedures means controls and other procedures . . . that are designed to ensure that information required to be disclosed by the issuer . . . is recorded."[45] While the SEC has not mandated or identified any specific set of "disclosure controls," it has recommended that companies establish a disclosure committee, which requires information to be communicated to management so that decisions regarding disclosure can be made.[46] In addition, many companies have implemented an array of disclosure procedures designed to comply with the certification requirements.[47]

The signing officers must also disclose any changes in the internal control over financial reporting during the course of the most recent fiscal quarter.[48] They must also disclose "all significant deficiencies and material weaknesses in the design and operation of the company's internal control over financial reporting," as well as "any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting."[49] "Internal control" refers to a process designed "to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting procedures."[50] The definition sets forth particular policies and procedures that fall within the definition of "internal control," (*e.g.*, maintenance of accurate records), but the final rule makes clear that "internal control" includes control related to the prevention, identification and detection of fraud.[51]

Finally, pursuant to Section 404 of Sarbanes-Oxley, the SEC has promulgated rules that require a company's annual report to include a statement that management is responsible for establishing and maintaining adequate internal control over financial reporting, identifying a framework used by management to conduct the required evaluation of the effectiveness of internal control, as well as management's assessment of the effectiveness of internal control. Sarbanes-Oxley and implementing SEC rules also require that a company's auditors issue an attestation report "on management's assessment of the registrant's internal control over financial reporting."[52] Management and the auditors must coordinate their processes for documenting and testing the internal control over financial reporting without eroding the independence of the auditors.[53]

Section 906 Certifications

Section 906 is a criminal statute enforced by Department of Justice. Criminal liability can only be imposed if the certification requirements are "knowingly" circumvented or if officers "knowingly" fail to implement system of accounting control or "knowingly" falsify books and records.[54] The 906 certification requires the signature of the CEO and CFO (or Chief Accounting Officer). They must certify that the report fully complies with Section 13(a) or Section 15(d). They must also certify that the information "fairly presents, in all material respects, the financial condition and results of operations of the issuer."[55] The statute has a bifurcated penalty structure under which an officer who knows the report does not comport with Sarbanes-Oxley is subject to one half of the fines and imprisonment as an officer who "willfully certifies" compliance "knowing" it does not.[56]

The Potential Impact of Certification Requirements

Because Sarbanes-Oxley requires that senior officers sign a public document certifying to the effectiveness of their control and procedures, the certifications may provide some link between senior management's "knowledge" and the adequacy of a company's controls systems. In addition, there is now required disclosure of problems in those control systems. Both of these changes could lead to more class action litigation, particularly because the enhanced disclosure benefits private plaintiffs who are not permitted to conduct discovery prior to pleading a viable complaint. More weak controls claims could also appear in derivative litigation, although courts have typically been loath to affix liability on board members for failure to supervise or monitor senior management in the absence of intentional or bad faith misconduct on the board's part.

Class Action Litigation

Allegations about inadequate internal controls have always appeared in securities class action complaints.[57]

They are usually just add-ons to other fraud allegations and are ordinarily never at the forefront of the litigation unless it moves past the pleading stage. The likely reason is that plaintiffs have difficulty finding support to link allegedly poor controls to the reckless conduct of senior management. Now, the CEO and CFO sign the certifications and, therefore, "make" the statements for securities law purposes.[58] These officers attest, based on their knowledge, to the effectiveness of disclosure controls and procedures, and their knowledge may be imputed to the company under common law agency principles.

There is no real difference when a signing officer allegedly knows about an undisclosed fraud at the time he or she signs the certification, but what about if the signing officer does not know of, let alone participate in, a serious accounting violation at the time he or she signs the certification? Now, plaintiffs may allege that the officer knew, or was reckless in not knowing, that the company's disclosure controls were ineffective and the internal controls were inadequate because they failed to detect, identify and prevent violations from occurring. Some courts have declined to dismiss claims against outside auditors because, among other things, they allegedly ignored "red flag" warnings, such as "incompatible accounting systems" and lack of adequate general ledger detail. This is precisely the type of accusation that could now be lobbed against officers who sign certifications, with or without any allegation of direct knowledge of or participation in the underlying wrongdoing.

The Private Securities Litigation Reform Act of 1995 (PSLRA) requires plaintiffs to plead with particularity that allegedly false statements were made with the requisite state of mind.[59] The PSLRA also imposes a stay of discovery until this standard is met.[60] The automatic discovery stay provides tremendous cost savings to companies, both in litigation expense and management attention. It also prevents plaintiffs from conducting the proverbial "fishing expedition" to bolster their claims. Sarbanes-Oxley requires companies to disclose "all significant weaknesses and deficiencies, as well as "any" fraud involving management or "other employees who have a significant role in the registrant's internal control over financial reporting."[61] As a result, some periodic reports now contain relatively detailed descriptions of deficiencies, as well as remediation efforts.[62] Plaintiffs will undoubtedly quote these descriptions, allege the signing officers were reckless in not knowing about the problems at the time, and use the detail to try to find support for their allegations.

Plaintiffs have difficulty finding support to link allegedly poor controls to the reckless conduct of senior management.

Class action plaintiffs typically attempt to support their claims with anecdotal evidence from anonymous and often disgruntled former employees.[63] Vague assertions of sloppy documentation or inadequate checks and balances could find their way into complaints to support claims premised on false or misleading certifications. While these accounts are usually found insufficient to allege that a high level officer knew, or was reckless in not knowing, the purported fraud occurred, it remains to be seen what (if any) evidential value they could have regarding knowledge of inadequate controls. Certainly, it is might be easier to find former employees who can complain about poor controls and procedures than those who witnessed fraud. If nothing else, these types of allegations will find their way into complaints simply in an attempt to lend credence to other allegations of fraud under the guise of supporting false certification claims.

Once companies begin to comply with Section 404, corporate defendants may argue that they relied on the auditor attestations to the adequacy and effectiveness of the company's internal control systems. Such attestations should negate any inference of recklessness, although this type of argument has had varying success at the pleading stage.[64] Moreover, the SEC has clarified that there are some elements of "disclosure controls and procedures" that are not subsumed by internal control over financial reporting, and the design of the former is up to the discretion of management.

More fundamentally, a question arises as to what false certification claims mean for securities litigation in general. Since the inception of the federal securities laws, courts have held that securities fraud claims cannot be premised on what essentially amounts to corporate mismanagement.[65] Litigating whether a signing officer knew, or was reckless in not knowing, that a

particular control system was inadequate comes close to the edge. For example, the issue could involve the misconduct of one or more employees, and plaintiffs could allege the system placed too much reliance on that employee without adequate secondary review. Yet, hiring and ultimately vesting trust in employees is part of managing a business. Cases about internal controls should not be allowed to erode the PSLRA or the purpose of Section 10(b) for that matter. As the Supreme Court pointed out, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."[66] The failure to design a control system that provides "reasonable assurance" regarding the reliability of financial reporting does not meet this standard.

Derivative Litigation

It is also possible that plaintiffs who bring derivative lawsuits will assert more inadequate controls claims in the wake of these new disclosures. Derivative lawsuits are typically brought by existing shareholders, on behalf of a company, against senior officers and directors, alleging breach of fiduciary duty in managing the company's affairs. A breach of the duty to monitor a company could arise from a board decision or from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."[67]

In the landmark *Caremark* case, the court acknowledged that directors have a duty "to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists." The court, however, regarded the plaintiffs' claim the directors failed to exercise proper supervision, as "possibly the most difficult theory in corporate law on which a plaintiff might hope to win a judgment."[68] The *Caremark* court held, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[69] Since then, courts have routinely dismissed "*Caremark* claims" absent an "extensive paper trail" or similar indicia depicting that the directors had direct knowledge of the wrongdoing.[70]

Sarbanes-Oxley arguably imposed heightened duties on members of a company's board of directors, particularly those who sit on audit committees, to be management watchdogs and ensure adequate internal and disclosure controls.[71] Sarbanes-Oxley has already affected the way the Delaware Chancery Court is viewing the conduct of board members.[72] Chief Justice Norman Veasey recently remarked that, while there is no private right of action for Sarbanes-Oxley violations, "if and when these reforms are presented as part of a board's conduct in a Delaware court where that conduct is relevant, adherence to these reforms may be relevant and would be advisable."[73]

Conclusion

Nobody, least of all a public company, would suggest that having a more adequate and effective controls system is a bad thing. Yet, the certification requirements will increase the likelihood of a company being named in private litigation, particularly if its control disclosure is accompanied by a stock drop.[74] Although the filing of such complaints cannot be prevented, it could not hurt to include risk factors warning that no control framework can ever provide absolute assurance that all instances of fraud will be detected and prevented.[75] Such warnings will not insulate companies from liability if, in fact, signing officers knew, or were reckless in not knowing, about actual fraud or serious problems that led to it. Yet, every control system is inherently limited by human error, mistakes in judgment, or individual (or collusive) acts of circumvention. Reminding investors of this reality might at least limit the company's "insurer's liability" when it comes to the effectiveness of their control frameworks.

NOTES

1. *http://www.us.kpmg.com/RutUS_prod/Documents/9/FINAL FraudSur.pdf.*
2. *See In re Cylink* Sec. Litig., 178 F. Supp. 2d 1077, 1087–1088 (N.D. Cal. 2001) (N.D. Cal. Aug. 29, 2001); *Cheney v. Cyberguard Corp*., No. 98-6879-CIV-GOLD, 2000 WL 1140306, at *7 (S.D. Fla. July 31, 2000) (denying corporation's motion to dismiss when plaintiffs adequately pleaded that one high ranking corporate officer possessed requisite scienter); *In re Sunbeam* Sec. Litig., 89 F. Supp. 2d 1326, 1340 (S.D. Fla. 1999) (denying corporation's motion to dismiss by imputing knowledge of individuals "who exercise[d] substantial control" to corporation).
3. Restatement (Second) of Agency § 140 (ALI June 2003).
4. *In re Atlantic Fin. Mgmt.*, Inc. Sec. Litig., 784 F.2d 29, 31–32 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987); *see also Commerford v. Olson*, 794 F.2d 1319, 1323–1324 (8th Cir. 1986) (finding district court's refusal to issue jury instruction on broker's "apparent authority" in connection with securities transactions reversible error); Restatement (Second) of Agency §§ 7, 8, 8A.
5. *See Kerbs v. Fall River Indus.*, Inc., 502 F.2d 731, 740–741 (10th Cir.

1974) (corporation liable for Section 10(b) violations by president "acting within the scope of his apparent authority as principal officer and agent of the corporation"), overruled on other grounds sub nom., *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *see also American Soc'y of Mech. Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 568 (1982) (chairman of subcommittee of nonprofit membership corporation); Atlantic, 784 F.2d at 35 (holding Section 20(a) "does not preclude the assertion of liability—based on common law notions of 'apparent authority'—against a corporation for the misrepresentations of an important corporate officer").

6. *See Atlantic*, 784 F.2d at 31-32; Kerbs, 502 F.3d at 740-741 (both citing Restatement of Agency § 261 (1958) ("A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud.")).

7. *See Atlantic*, 784 F.2d at 32. There is some support for applying "apparent authority" principles in other cases involving misrepresentation. *Id. (citing ASME*, 456 U.S. at 567–568 (nonprofit membership corporation liable for antitrust law violations by members acting with apparent authority); *Holloway v. Howerdd,* 536 F.2d 690, 696 (6th Cir. 1976) (liability of broker-dealer for Section 12(2) predicated on employee-broker's "apparent authority" in connection with sale of unregistered shares to class members)).

8. *See Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 384–385 (5th Cir. 2004); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577–1578 (9th Cir. 1990) (en banc); *Atlantic*, 784 F.2d at 32; *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 712–716 (2d Cir. 1980); *Holloway*, 536 F.2d at 694–695.

9. *See, e.g., Network Equip*., 762 F. Supp. 1359, 1365 (N.D. Cal. 1991) (the "scienter conflict between respondeat superior and Rule 10b-5 is not sufficient to bar the adoption of respondeat superior in the securities fraud context").

10. *Atlantic*, 784 F.2d at 32.

11. *Hollinger*, 914 F.2d at 1577 (quoting Paul F. Newton, 630 F.2d at 1118–1119).

12. *In re Healthsouth Corp. Shareholders Litig.*, 845 A.2d 1096, 1108 n.22 (Del. Ch. 2003), *aff'd*, 2004 WL 835879 (Del. 2004) ("When corporate fiduciaries, such as Healthsouth managers, have a self-interest in concealing information, such as the falsity of the financial statements that they had helped prepare, their knowledge cannot be imputed to the corporation."); *F.D.I.C. v. Shrader & York*, 991 F.2d 216, 223 (5th Cir. 1993); *F.D.I.C. v. O'Melveny & Meyers*, 969 F2d 744, 750 (9th Cir. 1992), *rev'd on other grounds*, 510 U.S. 989 (1993); *Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982); In re Cylink Sec. Litig.*, No. C-98-4294, 2001 WL 1551264 at *10 (N.D. Cal. Aug. 29, 2001); *In re Phar-Mor, Inc*. Sec. Litig., 900 F. Supp. 784, 786 (W.D. Pa. 1995) ("A corporation is not imputed with 'the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the [corporation] and entirely for his own or another's purposes.'"); *In re Investors Funding Corp. Sec. Litig.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980); *see also* 18B Am. Jur. 2d Corporations § 1680 (2003).

13. *F.D.I.C. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992).

14. *Id.* at 749.

15. *Cylink*, 2001 WL 1551264 at *10.

16. *Id*. at *11; *see also In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1340 (S.D. Fla. 1999) ("consistent with the general principles of agency and corporate law, the scienter of Sunbeam's officers is properly imputed to Sunbeam itself"); *cf. Zuckerman v. Smart Choice Auto. Group, Inc.*, No. 6:99-CV-237-ORL-99A, 2000 U.S. Dist. LEXIS 14676, at *18–19 (M.D. Fla. May 19, 2000) ("The acts of a corporate officer that are intended to benefit a corporation to the detriment of outsiders are properly imputed to the corporation.").

17. *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 522 (W.D. Pa. 2002); *see Phar-Mor*, 900 F. Supp. at 787 (officers' motive to overstate financial performance in order "to provide time for management to resolve [corporation]'s underlying business problems" does not equate to finding they intended to benefit corporation).

18. Rule 12(b)-2(f). *See Rochez Bros. v. Rhoades*, 527 F.2d 880, 890–891 (3d Cir. 1975) (adopting SEC's definition of "control").

19. Sandra P. Wysocki, Note, "Controlling Personal Liability of Directors Under Section 20(a) of the Securities Exchange Act of 1934," 31 *Suffolk U. L. Rev.* 695, 715 (1998).

20. *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969) ("The conclusion is inescapable that persons who act as directors are in control of the corporation.").

21. *See Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967); *cf. Hollinger*, 914 F.2d at 1574–1575 & n.24 (limiting application of "culpable participation" test in broker-dealer/registered representative context).

22. *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (plaintiff "must establish, first, that the defendant . . . 'actually participated in (*i.e.,* exercised control over) the operations of the corporation in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised.'").

23. A control person may avoid Section 15 liability by showing that he or she "had no knowledge or reasonable ground to believe in the existence of facts by reason of which the liability of the control person is alleged to exist," while Section 20 liability can be avoided if "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

24. *See Donohoe v. Consolidated Operating & Prod. Corp.*, 30 F.3d 907, 912 (7th Cir. 1994); *Hollinger*, 914 F.2d at 1575; *Paul F. Newton*, 630 F.2d at 1120.

25. *Hollinger*, 914 F.2d at 1574.

26. *See id.* at 1575.

27. *Id.* at 1576 (*quoting Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134–1135 (9th Cir. 1975)).

28. The First, Second, Fifth, Sixth, Eighth, and Ninth Circuits have held that the securities acts do not preclude secondary liability under *respondeat superior. Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d at 384–385; *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577–1578 (9th Cir. 1990) (en banc); *Atlantic*, 784 F.2d at 32; *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 712–716 (2d Cir. 1980); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *Holloway*, 536 F.2d at 694–695. The Third Circuit has reached the opposite conclusion, *Rochez*, 527 F.2d at 886, while the Fourth Circuit law is "in a state of confusion." *Hollinger*, 914 F.2d at 1577 n.27 (*compare Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975) *with Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir. 1979)).

29. *Hollinger*, 914 F.2d at 1577–1578.

30. *Atlantic*, 784 F.2d at 33.

31. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 201 n.12 (1994) (Stevens, J. dissenting); *In* re *Musicmaker.com Sec. Litig.*, 2001 WL 34062431, *12 n.5 (C.D. Cal. 2001).

32. *See, e.g.*, *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 172–173 (D. Mass. 2002) (citing cases); *AES Corp v. Dow Chemical Co.*, Civ.A. 99-673-JJF, 2001 WL 34367296 (D. Del. Jan. 19, 2001); *Lawton v. Nyman*, 62 F. Supp. 2d 533 (D.R.I. 1999); *Vento & Co. of New York LLC v. Metromedia Fiber Network, Inc.*, No. 97 Civ. 751 (JGK), 1999 WL 147732 (S.D.N.Y. Mar. 18, 1999); *Seolas v. Bilzerian*, 951 F. Supp. 978 (D. Utah 1997); A*T&T Co. v. Winback and Conserve Program, Inc.,* 42 F.3d 1421 (3d Cir. 1994); *compare Converse, Inc. v. Norwood Venture Corp.*, 96 Civ. 375 (HB), 1997 WL 742534 (S.D.N.Y. Dec. 1, 1997).

33. *Lake v. Kidder Peabody & Co.*, No. S 75-147, 1978 WL 1101 (N.D. Ind. May 22, 1978).

34. *Id*. at *14.

35. *Id.*

36. *In re Network Equip. Tech., Inc. Litig.*, 762 F. Supp. 1359 (N.D. Cal. 1991).

37. *Id.* at 1364–1365.

38. *In re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 752 (S.D.N.Y. 1985) ("As to [the corporation], plaintiffs arguably need only show . . . that . . . [corporate] management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace."); *Caterpillar, Inc. v. Great American Ins. Co.*, 62 F.3d 955, 962 (7th Cir. 1995) (noting in dicta "there are conceivable situations in which the individual actors would not be liable but their corporate employer would be, for example where a case depends on the collective scienter of its employees or where defenses are available to individuals but not the corporation.").
39. *See Southland*, 365 F.3d at 366; *Piper Jaffray Cos. v. National Union Fire Ins. Co.*, 38 F. Supp. 2d 771, 778–779 (D. Minn. 1999); *see also In re Apple Computer, Inc.* Sec. Litig., 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002) ("It is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false.").
40. *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1436 (9th Cir. 1995). The viability of "collective scienter" is also called into doubt by the proportionate liability provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA). The PSLRA changed the prior joint and several liability scheme by enacting a scheme of proportionate liability pursuant to which a jury must apportion fault between those persons who act knowingly (*e.g.*, rogue employees) and those who do not (*e.g.*, innocent officers and directors). 15 U.S.C. §§ 78u-4(f)(10)(A), 78u-4(f)(10)(C). Consequently, persons who act knowingly are still jointly and severally liable for all of the damages, while persons who do not act knowingly are liable only for their proportionate share of total damages. 15 U.S.C. §§ 78u-4(f)(2)(A), 78u-4(f)(2)(B)(i). Under this scheme, the percentage of responsibility assigned to non-culpable actors dramatically undermines the likelihood of recovery on a collective scienter theory for fraud committed by low-level employees. See 15 U.S.C. § 78u-4(f)(3)(A) (requiring jury finding regarding the percentage of responsibility of each person compared with the total fault of all persons, named as parties or not, who caused or contributed to plaintiffs' loss).
41. 15 U.S.C. § 7241.
42. Rules 13a-14 and 15d-14.
43. *Id.*
44. 17 C.F.R. § 229.601; *see also* Rules 13a-14 and 15d-14. A "fair" presentation of financial condition is not limited to a representation that the financial statements follow GAAP. See SEC Adopting Release No. 33-8124 (Aug. 29, 2002) ("Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.").
45. Rule 13a-15.
46. Robert J. Haft, "Venture Capital and Small Business Financing," 2A *Venture Cap. & Bus. Fin.* § 14:16 (April 2004); SEC Release No. 33-8124 at *9 (Aug. 28, 2002); *see*, *e.g.*, *SEC v. Worldcom, Inc.*, No. 02 Civ. 4963 (JSR), 2003 WL 22004827 at *54–55 (S.D.N.Y. Aug. 26, 2003).
47. 1377 PLI/Corp 11 at *29–30.
48. 17 C.F.R. § 229.601.
49. A "material weakness" exists when there is more than a remote likelihood that a material misstatement will not be prevented or detected. "More than remote" is defined as reasonably possible or probable. A "significant deficiency" exists where there is a more than remote likelihood that a misstatement that is more than inconsequential will not be prevented or detected. A "significant deficiency" includes ineffective oversight by an audit committee as well as a material misstatement not initially identified by internal controls. As the PCAOB recently observed, "[t]hat the company's internal controls did not first detect the misstatement is, therefore, a strong indicator that the company's internal control over financial reporting is ineffective." PCAOB Release No. 2004-001 (March 9, 2004).
50. Rule 13a-15.
51. SEC Release No. 33-8238, 2003 WL 21294970, at *8 (June 5, 2003) (citing COSO Report at 130 & Exchange Act Rules 13a-14(d) and 15d-14(d)).
52. SEC Release No. 33-8238, 2003 WL 21294970, at *11 (June 5, 2003).
53. SEC Release No. 33-8238, 2003 WL 21294970 at *10 (June 5, 2003).
54. *See* 18 U.S.C. § 1350; Public Law 107–204 (July 30, 2002), 116 Stat. 806 § 906(a).
55. 18 U.S.C. § 1350(b).
56. Former Healthsouth CEO Richard Scrushy has moved to dismiss criminal charges that allege he willfully certified a quarterly report and caused or attempted to cause others to willfully certify annual and quarterly reports. He is claiming Section 906 "seeks to hold corporate officers derivatively liable for conduct that, when committed by another, may itself be non-criminal" (*i.e.*, non-compliance with Sections 13(a) and 15(d)).
57. *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424 (5th Cir. 2002); Riggs *Partners, LLC v. Hubb Group, Inc.*, No. 02 C 1188, 2002 U.S. Dist. LEXIS 20649 (N.D. Ill. Oct. 25, 2002); *In re Glenfed Sec. Litig.*, 42 F.3d 1542, 1552–1553 (9th Cir. 1994).
58. *See* SEC Release No. 33-8124 at *8 (Aug. 28, 2002); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057 (9th Cir. 2000) (officer who signs a document filed with the SEC "makes" a statement within the meaning of Section 10(b)).
59. Section 10b-5 of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b).
60. *See, e.g.*, Section 27(b)(3) of the Securities Exchange Act of 1933, 15 U.S.C. § 77z1(b)(3).
61. The SEC has clarified that disclosure of the nature of significant deficiencies is required only if, when combined with other significant deficiencies, it is determined to be a material weakness and disclosure of the nature of the significant deficiencies is material to an understanding of the material weakness disclosure. *See* Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports—Frequently Asked Questions, Question No. 11, *http://www.sec.gov/info/accountants/controlfaq0604.htm*.
62. According to Compliance Week, 92 companies disclosed material weakness or significant deficiencies in internal controls in August 2004. That number increased from 36 in July 2004. Compliance Week (Sept. 8, 2004), *www.complianceweek.com*.
63. *See, e.g., Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000); *In re Homestore.com*, *Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1033 (C.D. Cal. 2003); *In re U.S. Aggregates, Inc*. Sec. Litig., 235 F. Supp. 2d 1063, 1074–1075 (N.D. Cal. 2002).
64. *See, e.g., In re SeeBeyond Sec. Litig.*, 266 F. Supp. 2d 1150, 1168 (C.D. Cal. 2003) (denying motion to dismiss in spite of defendants' argument that inference of scienter is negated where outside auditors certified financial statements); *In re Lernout & Hauspie* Sec. Litig., 208 F. Supp. 2d 74, 86–87 (D. Mass. 2002) ("Defendants protest too much that they fully relied, and were entitled to rely, on L & H's auditors, various arms of KPMG. They claim that the Complaint's allegations of KPMG's intimate involvement with the preparation of L & H's financial statement negated the inference of *scienter*. Not so.").
65. *SEC v. Zandford*, 535 U.S. 813, 821 (U.S. 2002) ("We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 (1977) (allegations of corporate mismanagement are not actionable under Rule 10b-5).
66. *Central Bank*, 511 U.S. at 174 (*quoting Chiarella v. U.S.*, 445 U.S. 222, 234–235 (1980)).
67. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).
68. *Id.; see also Rattner v. Bidzos*, No. Civ. A.19700, 2003 WL 22284323 at *12 (Del. Ch. Sept. 30, 2003) ("a claim for failure to exercise proper oversight is one of, if not the, most difficult theories on which to prevail") (demand not excused based on directors' alleged failure to exercise proper supervision over financial recording and reporting systems).
69. *Caremark*, 698 A.2d at 971.
70. *See In re Abbott Labs. Deriv. Shareholders Litig.,* 325 F.3d 795, 809 (7th

Cir. 2003); *Guttman v. Huang,* 823 A.2d 492, 506 (Del. Ch. 2003) (Caremark "premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.").

71. SEC Release No. 8238, 2003 WL 21294970, at *20 (June 5, 2003).

72. Recently, the Delaware Supreme Court overturned the lower court's opinion absolving the directors from misconduct in connection with approving the CEO's (Eisner) unilateral decision to pay his close personal friend (Ovitz) more than $140 million for a brief and below-average stint as president of the company. *In re Walt Disney Co. Deriv. Litig.,* 825 A.2d 275, 278 (Del. Ch. 2003). The directors allegedly authorized hiring Ovitz without reviewing or obtaining any expert advice concerning the proposed employment agreement, which Eisner personally negotiated. The court found the allegations, if true, showed the directors "knew that they were making material decisions without adequate information and without adequate deliberations" but they "simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss." *Id.* at 289.

73. "Post-Enron Reforms Reshaped Corporate Governance, Delaware Chief Justice Says," 19 No. 9 Andrews Corp. Off. & Directors Liab. Litig. Rep. 3 (Nov. 17, 2003).

74. *See, e.g.*, *Fener, et al. v. Belo Corp., et al.*, Complaint for Violations of Federal Securities Laws ¶¶ 17, 21, 25, 31, 35 (N.D. Texas Aug. 23, 2004) (alleging certifications in quarterly and annual reports attesting to disclosure controls and procedures were false and misleading); *Gottfried, et al. v. CP Ships Ltd., et al.*, Class Action Complaint for Violations of Federal Securities Laws ¶¶ 34, 38–40, 42(c) (M.D. Fla. Aug. 2004) (quoting certifications and alleging defendants failed to maintain an adequate system of internal financial and operational controls); *Bassin, et al. v. deCODE Genetics, Inc., et al.*, Complaint for Violation of the Federal Securities Laws (S.D.N.Y. Sept. 1, 2004) (class action premised on company's announcement of "reportable condition" with respect to internal controls); English, et al. v. Integrated Electrical Servs., Inc., Class Action Complaint ¶33 (S.D. Tex.) (alleging statements in press releases and SEC filings were false and misleading because defendants failed to disclose the Company "lacked adequate internal controls"); *South Ferry LP #2, et al. v. Killinger, et al.*, Class Action Complaint for Violations of the Federal Securities Laws ¶¶ 4, 35(c) (W.D. Wash. July 20, 2004) (alleging "it was materially false and misleading for defendants to claim that defendants maintained adequate systems of internal financial, operational or market controls").

75. *See, e.g., Lucille Farms, Inc. 10-K* at Item 9 (filed July 1, 2004) ("The Company does not expect its disclosure controls and procedures will prevent all error and fraud. . . Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected."); Carmike Cinemas, Inc. Form 424B3 at 16 (filed July 30, 2004) ("Due to the ongoing evaluation and testing of our internal controls, there can be no assurance that there may not be significant deficiencies or material weaknesses that would be required to be reported."); Symbol Technologies, Inc. 10-K at 17 (filed Dec. 30. 2003) ("If we are unable to effectively and efficiently implement our plan to remediate the material weaknesses which have been identified in our internal controls and procedures, there could be a material adverse effect on our operations or financial results.").

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