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Despite Initial Fears To The Contrary, It Appears That Sarbanes-Oxley Gave Private Litigants A "Dull Sword" When It Comes To Piercing The Corporate Veil

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DESPITE INITIAL FEARS TO THE CONTRARY, IT APPEARS THAT SARBANES-OXLEY GAVE PRIVATE LITIGANTS A "DULL SWORD" WHEN IT COMES TO PIERCING THE CORPORATE VEIL

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INTRODUCTION

Over the past several years, accountants have managed to ride out the storm of massive corporate accounting scandals, the demise of one of the premier accounting firms in the country, a tarnished perception of the profession, and the resulting impact of the landmark passage of Sarbanes-Oxley ("SOX").[3] Even though the worst seems to be behind us, the question still remains – are there still more ticking financial time-bombs sitting out there waiting to go off? If so, are investors better protected from economic ruin by Sarbanes-Oxley and related regulation? Despite early hopes and predictions that this legislation would stop future scandals and restore investor confidence, the jury is still out on whether this landmark legislation truly affords investors the protections it was intended to provide.

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3. Bill Carlino, *After Major Repairs, Profession Awaits Detail Work*, ACCOUNTING TODAY, Sept. 20, 2004, at 42.

Just over seven years ago in December of 2001, Enron – the nation's seventh largest company based on reported revenues – filed for Chapter 11 bankruptcy, touching off an eruption of accounting scandals that rocked the financial world.[4] At the time, Enron's collapse was the largest corporate bankruptcy in American history, bringing down a company with approximately $33 billion in assets.[5] Over a four-year period, Enron's executives engaged in a fraudulent accounting scheme that included overstating profits and understating debts to drive up the stock price. As the scheme unraveled, investors lost tens of billions of dollars as the stock price plummeted from a high of near $90 a share to less than $1 a share.[6] All of this occurred despite the auditing oversight by one of the largest and most reputable accounting firms at the time – Arthur Andersen.

Both Congress and the public were outraged that a fraud of such magnitude could be committed. At the urging of the President, Congress initiated hearings to examine the Enron collapse and to develop a plan to prevent similar fraudulent financial schemes from occurring in the future. Nevertheless, over the next half-dozen years, several other major American corporations such as Worldcom (2002), Adelphia Communications (2002), HealthSouth (2002), Qwest (2002), NYSE (2003), Parmalat (2003), Marsh and McLennan (2004), AIG (2005), Krispy Kreme (2005), and Fannie Mae (2006) followed the way of Enron and suffered economic collapse as a result of colossal accounting irregularities, insider trading, or outright theft.[7]

In the midst of these very visible corporate implosions, accountants, attorneys, and other professionals and organizations who advised public companies were concerned over their expanding exposure as securities fraud plaintiffs and their respective counsel continually crafted new ways to claim that the former acted as enablers, or worse yet, contributors to the frauds committed by the public companies.[8] The theory prof-

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4. Jaclyn Taylor, *Fluke or Failure? Assessing the Sarbanes-Oxley Act After* United States v. Scrushy, 74 U.M.K.C. L. REV. 411, 415 (2005).

5. *Id.*

6. *Id.*

7. Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 8 (2007); *see also* John Patrick Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005 (2004).

8. *See* Peter Geier, *Creative Litigation Ensnares Outside Counsel in Shareholder Suits*, NAT'L L. J., Jan. 24, 2006, *available at* http://www.law.com/jsp/ihc/PubArticle

fered is that the "fraud[s] could not have taken place without lawyers' and accountants' advice to their clients . . . ."[9] As a result, Wall Street, accounting firms, and outside counsel have not escaped unscathed. Arthur Andersen collapsed as a result of its role in auditing Enron and subsequently shredding Enron's documents while it was the subject of a federal investigation.[10] Similarly, Merrill Lynch, J.P. Morgan, Citigroup, and many other brokerage firms have been investigated for a myriad of alleged unethical activities. Finally, law firms, including Enron's legal counsel, Vinson & Elkins, which found itself as a defendant in the Enron multidistrict litigation,[11] and Buchanan Ingersoll and Mayer Brown, have been named as defendants in investor suits.[12]

While Enron crumbled and investigators uncovered Arthur Andersen's role, the American public screamed for the government to intervene and prevent such economic disasters from happening again. On July 30, 2002, President Bush signed the Sarbanes-Oxley Act.[13] One of the major goals of SOX was to create an environment of greater corporate integrity and investor confidence by holding company officers personally accountable for financial misdeeds. For example, Sections 302 and 906 of SOX, the so-called "certification provisions" wherein high-level executives certify to the Securities and Exchange Commission ("SEC") that the company's regulatory filings are accurate, were drafted with the idea of "creat[ing] a link between the person and the document."[14] In fact, the impetus behind the inclusion of provisions that require CFOs and CEOs to certify financial statements to be filed with the SEC was that Congress intended these to be critical pieces of the statutory puzzle to preventing corporate corruption and fraud.[15] These provisions subjected corporate officers to personal civil and criminal liability unlike ever before. In fact, early predictions were that these

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IHC.jsp?id=1138023312254 (discussing the rise in litigation against law firms and attorneys in their roles as advisors to companies being sued for securities violations).

9. *See id.*

10. *Timeline of Enron's Collapse*, WASH. POST, Sept. 3, 2004, http://www.washingtonpost.com/wp-dyn/articles/A25624-2002Jan10.html (last visited Jan. 18, 2009).

11. Harshbarger & Jois, *supra* note 7, at *8 (2007); Geier, *supra* note 8.

12. *See* Geier, *supra* note 8.

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

14. Jonathan D. Glater, *New Rules Make it Easier to Charge Executives, But Not to Send Them to Prison*, N.Y. TIMES, July 2, 2005, at C5.

15. *Id.*

"veil piercing" provisions were going to be an effective tool for preventing future scandals and for restoring investor confidence.[16]

Six years later, some experts still agree. "It's a terrific piece of legislation . . . it's worked very well," said Chuck Bowsher, former U.S. Controller General.[17] "We're in much better shape today than we were prior to Sarbanes-Oxley . . . [t]he markets were in turmoil, corporations were in disrepute. There was a real fear that the lack of trust in the markets could create long-term problems."[18] But across the corporate landscape, not everyone agrees with these rosy characterizations. It appears that SOX, particularly Section 302, has not made prosecuting corporate officers any easier than it was under traditional veil piercing methods. As noted by one observer, "[p]erhaps forcing top executives to certify regulatory filings is not quite the fix lawmakers might have expected."[19] Moreover, some business groups have complained that post-Enron regulation has made American markets less competitive and has driven companies issuing stock to overseas exchanges.[20] All this has left many in the financial community pondering the question: What impact did SOX have on the financial marketplace?

Part I of this Article provides a look at the pleading requirements and realistic opportunity, or lack thereof, of piercing the corporate veil under traditional pre-SOX litigation rules. Part II examines the impact, if any, that SOX has had on litigants' opportunities to include corporate officers as defendants in securities litigation cases. Part III introduces some recent cases where courts, including the Supreme Court, have interpreted the veil piercing provisions in SOX and related regulation. Part IV describes the more recent trend to weaken or loosen the regulation based on the perceived or actual impact SOX has had on the securities industry, while Part V briefly addresses some alternate approaches to regulating the securities industry that have been adopted in other countries. Finally, the Article concludes with some suggestions con-

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16. Greg Farrell, *Sarbanes-Oxley Has Been a Pretty Clean Sweep*, USA TODAY, July 30, 2007, at 6B.

17. *Id.*

18. *Id.* (quoting former SEC Commissioner Harvey Goldschmid).

19. Glater, *supra* note 14.

20. Stephen Labaton, *Is the S.E.C. Changing Course?*, N.Y. TIMES, Mar. 1, 2007, at C1 (discussing recent comments by Christopher Cox, the SEC Chairman, wherein he argued that the tough new regulations were good for competition and were not the driving force behind the migration of businesses to European exchanges).

cerning the direction regulators and lawmakers should take when looking at the U.S. securities industry.

I. A LOOK AT THE TRADITIONAL PLEADING REQUIREMENTS OR HURDLES FACED BY LITIGANTS ATTEMPTING TO PIERCE THE CORPORATE VEIL

Historically, limited liability in the corporate sense meant that shareholders were not liable for debts owed to the corporation's creditors. The common response in these instances was for the creditor to try to bring suit against one or more of the corporation's shareholders and argue that liability should be extended beyond the confines of the corporate structure directly to the shareholders.[21] This is commonly referred to as "piercing the corporate veil."[22] Generally, a court considers several critical factors when deciding whether or not to pierce the corporate shield and impose liability on a shareholder. These include, but are not limited to: defendant's wrongful dealings with the plaintiff, defendant's abusive dealings with corporate assets, and inadequate capitalization.[23] Successfully piercing the corporate veil is often referred to as a "Herculean task"; courts are not quick to ignore the corporate formalities and extend liability directly to shareholders, recognizing that "veil piercing is an extraordinary procedure that should not be used lightly."[24]

A. The Securities and Exchange Act of 1934 and The SEC Rules

Actions seeking to pierce the corporate veil with allegations of securities fraud are typically brought under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act")[25] and SEC Rule 10b-5[26]. Section 10(b) of the Exchange Act forbids:

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21. Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 853 (1997).
22. *Id.*
23. *Id.* at 854.
24. Schattner v. Girard, Inc., 668 F.2d 1366, 1370 (D.C. Cir. 1981).
25. 15 U.S.C. § 78j(a) (2008).
26. 17 C.F.R. § 240.10b-5 (2008).

> the use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.[27]

SEC Rule 10b-5 implements Section 10(b) by declaring the following to be unlawful:

> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made . . . not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[28]

Prior to the passage of SOX in 2002, corporate officers could only be held personally liable for alleged violations of Section 10(b) or Rule 10b-5 if a plaintiff could demonstrate that the officer himself committed a breach of fiduciary duty sufficient to warrant piercing the corporate veil.[29] When pleading a securities fraud claim under section 10(b) of the Exchange Act and SEC Rule 10b-5, a plaintiff has to allege fraud "with particularity" in order to survive a motion to dismiss.[30] That is, a plaintiff is required to plead that there was: (1) a misrepresentation or omission of a material fact; (2) made with *scienter*; (3) in connection with the purchase or sale of a security; (4) relied on by plaintiff; that (5) proximately caused (6) plaintiff's economic loss.[31] The plaintiff's claims are then subject to review under the heightened standard for fraud claims under the Federal Rules and it is widely accepted that generalized or conclusory allegations of fraudulent conduct will not satisfy Rule 9(b) of the Federal Rules of Civil Procedure.[32] To satisfy Rule 9(b), a plaintiff

27. 15 U.S.C. § 78j(b).
28. 17 C.F.R. § 240.10b-5.
29. *See* Jeannie Nelson, *New Corporate Responsibility Law Increases Liabilities for Directors, Officers, and Attorneys, But Does it Increase Protections for Investors?*, 34 TEX. TECH. L. REV. 1165, 1167 (2003).
30. FED. R. CIV. P. 9(b).
31. 15 U.S.C. § 78j(b); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).
32. Rule 9(b) of the Federal Rules of Civil Procedure requires that the circum-

must "specify the alleged fraudulent statements, the speaker, when and where the statements were made, and why they are fraudulent."[33] Thus, trying to establish fraudulent intent on the part of a corporate officer at the pleading stage and before any discovery is nearly impossible.

B. The Private Securities Litigation Reform Act

In 1995, Congress further heightened the pleading standard for securities fraud claims by passing the Private Securities Litigation Reform Act ("PSLRA").[34] Under the PSLRA, a plaintiff is required to "state with particularity, facts giving rise to a *strong inference* that the defendant acted with the required state of mind" necessary to prove fraud.[35] "State of mind", or scienter, is a "mental state embracing intent to deceive, manipulate or defraud."[36] That is, a plaintiff must plead a "strong inference that the defendant[s] acted at least recklessly" in making false statements, or with knowledge of their falsity.[37] Recklessness under the PSLRA is "a mental state apart from negligence and akin to conscious disregard."[38] Typically, litigants would surmise that proof that the corporation's financial statements were false would be enough to establish intent. Courts, however, have routinely held that subsequent revelations that financial statements were false could not, standing alone, create this strong inference of scienter.[39]

One could certainly make the claim that the aforementioned hodgepodge of regulation can be confusing. Not only have these requirements made pleading securities fraud more difficult for plaintiffs, but in passing the PSLRA, Congress also muddied the waters by not defining the terms "scienter" or "strong inference". It appears that these terms were deliberately left undefined; Congress stated it did not intend to

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stances constituting the fraud must be pled with particularity.

33. Fin. Acquisition Partners LP v. Blackwell, 440 F.3d 278, 287 (5th Cir. 2006).

34. 15 U.S.C. § 78u-4(b)(3)(A).

35. *Id.* § 78u-4(b)(2) (emphasis added).

36. *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 548 (6th Cir. 1999) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).

37. Helwig v. Vencor, Inc., 251 F.3d 540, 551 (6th Cir. 2001).

38. *In re* Comshare, 183 F.3d at 550.

39. *In re* Goodyear Tire & Rubber Co. Sec. Litig., 436 F. Supp. 2d 873, 896 (N.D. Ohio 2006) (holding that the plaintiffs could not impute such knowledge sufficient to establish scienter to the individual defendants merely because they certified the financial statements).

codify how these standards should be met.[40] After the PSLRA was passed in the House of Representatives, the Senate attempted to amend it to include a provision that recognized motive and opportunity as a basis for liability so that litigants would better understand what they needed to do to meet the pleading requirements for securities fraud.[41] Ultimately this amendment was not adopted and President Clinton vetoed the bill, claiming it erected a "higher barrier for litigants" to bringing suit than what was currently in existence and would result in "even the most aggrieved investors with the most painful losses" having their cases dismissed at the pleading stage.[42] Despite these concerns, Congress overrode the veto and the PSLRA was enacted without the amendment proposed by the Senate.

There has been some non-legislative guidance to interpreting the terms "strong inference" and "scienter." Prior to the passage of the PSLRA, the U.S. Circuit Court of Appeals for the Second Circuit held that pleading a "strong inference" of scienter could be established by showing that: (1) the defendant acted recklessly; (2) the defendant had the motive and opportunity to commit fraud;[43] or (3) the defendant, a corporate insider, "misrepresented to the public material facts about the corporation's performance or prospects in order to keep the stock price artificially high."[44] While this interpretation aided litigants in the Second Circuit, however, it was not the interpretation used by all courts. In fact, the circuit courts have split on these definitions, with the Ninth Circuit raising the scienter element to require strong evidence of deliberately reckless or conscious misconduct.[45] The Sixth and Eleventh Circuits, in contrast, have taken the middle road between the Second and Ninth Circuits, holding that a showing of motive and opportunity alone are not sufficient to meet the scienter requirement.[46]

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40. H.R. Rep. No. 104-369 (1995).

41. *Helwig*, 251 F.3d at 549 (citing 141 Cong. Rec. S9171 (daily ed. June 27, 1995) (statement of Sen. Spector)).

42. 141 Cong. Rec. S19035 (daily ed. Dec. 21, 1995) (veto message of President Clinton).

43. Acito v. IMCERA Group, Inc., 47 F.3d 47, 52 (2d Cir. 1995).

44. Novak v. Kasaks, 216 F.3d 300, 307-8 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000).

45. *In re* Silicon Graphics Litig., 183 F.3d 970, 974 (9th Cir. 1999).

46. Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1287 (11th Cir. 1999); Garfield v. NDC Health Corp., 466 F.3d 1255, 1265-66 (11th Cir. 2006) (holding that the plain meaning of language contained in the Sarbanes-Oxley Act does not indicate any intent

II. HAVE THE PLEADING REQUIREMENTS FOR FRAUD BEEN IMPACTED BY THE PASSAGE OF SARBANES-OXLEY?

Post Sarbanes-Oxley, the SEC and investors were expected to have a much greater ability to hold a corporation's officers accountable for financial and accounting misdeeds. Under Section 302 of Sarbanes-Oxley, CEOs and CFOs are required to personally certify every annual or quarterly report that the company files with the SEC under Sections 13(a) or 15(d) of the Exchange Act[47]. This certification process is meant to provide evidence that the officer reviewed the report and that to the best of that officer's knowledge, the report does not contain any untrue statements or omissions of material fact, and that the information in the report fairly represents in all material respects the financial condition of the corporation. The rule requires that the principal financial officer must certify to his or her knowledge that:

(1) the signing officer has reviewed the report;
(2) the report does not contain any untrue statement of material fact;
(3) that the financial information fairly presents in all material respects the financial condition of the issuer;
(4) that the signing officer is responsible for:
    (a) establishing and maintaining internal controls of the company;
    (b) that those controls have been designed to ensure that material information relating to the company is known to the officers and others; and
    (c) that they have evaluated effectiveness of those controls; and
(5) that the signing officers have disclosed to the auditors and audit committee:
    (a) any significant deficiencies in the design or operation of the internal controls;

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to change the pleading requirements for pleading scienter set forth in the PSLRA and that section 302 certifications are only probative of scienter if the person signing them was severely reckless).

47. 15 U.S.C. § 7241(a) (2008).

(b) any fraud whether or not material that involved management or other employees who have a significant role in the issuer's internal controls; and

(c) any significant changes in the internal controls.[48]

Violations of Section 302 may lead to civil liability for failing to meet SOX reporting requirements.[49] Additionally, violations finding material misstatements or omissions concerning the company's financial status that subsequently mislead investors may give birth to a cause of action brought by either the SEC or private investors[50].

Section 906 of Sarbanes-Oxley requires that the reporting corporate manager certify in a written statement that each report submitted to the SEC contains information that is a fair representation of the corporation's financial status. A knowing violation of this certification provision can result in 10 years in imprisonment and a $1 million fine.[51] A willful violation would be punishable by up to 20 years imprisonment and a $5 million fine.[52]

Thus, in essence Sections 302 and 906 were intended to be a codification of the "piercing the corporate veil" doctrine by requiring a corporate officer to expose himself to civil and criminal liability by certifying that he was directly responsible for the content of the SEC filings. These provisions were intended to make it easier for litigants and prosecutors to get to the individual officers responsible for the fraud. In fact, as noted by one decision, the signing of the Sarbanes-Oxley certifications gives rise to an inference of scienter because the certifications evince the officer's state of mind and establish that the corporate officer knew or should have known about the improper financial reporting.[53] Securities experts have acknowledged that the certification provisions were designed to prevent top executives from using a "head in the sand" defense to actions alleging securities fraud committed on their watch.[54]

48. *Id.*; *see also* Jenny B. Davis, *Sorting Out Sarbanes-Oxley: Determining How to Comply with the New Federal Disclosure Law for Corporations Won't Be Easy*, 89 A.B.A.J. 44 (Feb. 2003).

49. *See* Davis, *Sorting Out Sarbanes-Oxley*, *supra* note 48.

50. *Id.*

51. 18 U.S.C. § 1350(c)(1) (2002).

52. *Id.*

53. *See In re* Lattice Semiconductor Corp., Sec. Litig., 2006 U.S. Dist. LEXIS 262, *50 (D. Or. 2006).

54. *See* Davis, *Sorting Out Sarbanes-Oxley*, *supra* note 48.

Indeed, a statement from the SEC warned corporate officers that submitting a signed false certification under SOX could expose them to both Commission and private actions for violations of Section 10(b) and Rule 10b-5.[55]

Along with the above, Section 101 of SOX required the formation of the Public Accounting Oversight Board (PCAOB).[56] The PCAOB was charged with overseeing the audits of public companies in an effort to provide additional assurances that the interests of investors were served by the generation of informative, fair, and independent audit reports.[57] The PCAOB is a non-profit private-sector corporation comprised of a five-member board appointed by the SEC after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. Only two of the five Board members must be, or must have been, certified public accountants and all members of the Board serve on a full-time basis.[58] The PCAOB has the power to: (1) establish or adopt ethics regulations and standards relating to the preparation of audit reports, (2) perform inspections of public accounting firms, (3) conduct investigations, hold disciplinary hearings, and impose sanctions, and (4) enforce compliance with the others provisions of SOX.[59]

One could easily believe that, in light of the above, corporate executives would be less likely to get away with certifying false or fraudulent financial information to the SEC and/or public. Nevertheless, the question remains – is submitting a false certification under Section 10(b) of SOX and SEC Rule 10b-5 enough to prove scienter and to enable a litigant to pierce the corporate veil? The question appears to be a difficult one to answer with any degree of certainty. The federal circuit courts are split into three different camps when it comes to determining what exactly is required to satisfy the PSLRA's pleading requirements for scienter. The split is as follows: one camp consists solely of the Ninth Circuit; another is comprised of the Second and Third

55. Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8124, at 34 (Aug. 29, 2002).

56. 15 U.S.C. § 7211(a) (2002).

57. Sabyasachi Ghoshray, *Impact of Sarbanes-Oxley on Multiple Listed Corporations: Conflicts in Comparative Corporate Laws and Possible Remedies*, 10 ILSA J. INT'L & COMP. L. 447, 450 (Spring 2004).

58. 15 U.S.C. § 7211(e)(1)-(3).

59. *Id.*

Circuits; and the last and largest camp encompasses the First, Fourth, Fifth, Sixth, Seventh, Eighth, Tenth, and Eleventh Circuits.[60]

The Ninth Circuit has set forth the strictest interpretation of the pleading standard in the case of *In re Silicon Graphics Inc. Securities Litigation*.[61] The court held that, at a minimum, a plaintiff must plead "particular facts giving rise to a strong inference of *deliberate or conscious recklessness*."[62] The Ninth Circuit's holding has been described as creating a "super-recklessness" standard, which has been criticized as being too restrictive by other circuit courts.[63]

Conversely, the Second and Third Circuits have employed what can be characterized as the most pro-plaintiff standard in the country.[64] The Second and Third Circuits agree that "plaintiffs must allege facts showing (a) both motive and opportunity, or (b) strong circumstantial evidence of conscious misbehavior or recklessness."[65]

Sitting somewhere in the middle between the two extremes are the eight remaining circuits. While there is not a pure consistency among these eight circuits, it is fair to say they agree that, as a general rule, pleading motive and opportunity alone is not sufficient to demonstrate

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60. Mark Gideon, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 Conn. L. Rev. 1097, 1159 (2007) (noting that the D.C. Circuit itself has not yet weighed in on the subject but that there have been some District Court opinions from the D.C. Circuit).

61. *In re* Silicon Graphics, 183 F.3d 970, 979 (9th Cir. 1999); *see also* Gompper v. VISX, Inc., 298 F.3d 893 (9th Cir. 2002); DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385 (9th Cir. 2002).

62. *Silicon Graphics*, 183 F.3d at 979 (emphasis added).

63. Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 n.21 (11th Cir. 1999) (stating that "[t]o the extent that the effort in *Silicon Graphics* is an attempt to import into the law a new and uncertain super-recklessness, we believe that the attempt is inconsistent with the plain statutory language") (citation omitted).

64. Ryan G. Miest, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1133 (1998) (positing that eliminating the use of "motive and opportunity test" employed by the Second Circuit does not hamper the private enforcement function of 10b-5 actions, rather, the increased difficulty of pleading scienter without utilizing the motive and opportunity test may result in fewer claims filed and those plaintiffs who are dissuaded by a stronger standard are precisely the litigants the PSLRA was enacted to deter).

65. Rombach v. Chang, 355 F.3d 164, 176 (2d Cir. 2004); Kemp v. Universal Am. Fin. Corp., 2007 U.S. Dist. LEXIS 2162, at 32 (S.D.N.Y. 2007); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 532 (3d Cir. 1999); *In re* Alpharma Inc. Sec. Litig., 372 F.3d 137, 148 (3d Cir. 2004).

scienter, and that a plaintiff must also provide facts sufficient to support a strong inference of recklessness.[66]

The split among the circuits is only the "tip of the iceberg" when it comes to the problem of ascertaining what precisely a plaintiff must do to establish scienter. The federal district courts are even more erratic than the circuit courts when it comes to addressing the PSLRA's "strong inference" of scienter. As noted in a 2002 study of 167 district rulings regarding the issue, researchers found "aggregate patterns of behavior that are, to a remarkable degree, statistically indistinguishable from a 'coin-toss' model of judicial behavior."[67] The authors of the study posit that:

> judges who are unconstrained by appellate precedent frequently adopt minimalist strategies that avoid the need to interpret the statute. They rule either that a complaint is sufficiently strong that it satisfies the most stringent conceivable articulation of the pleading standard, or that it is so deficient that it fails the most forgiving articulation, without explaining how the 'strong inference' standard is to be interpreted or applied.[68]

In August of 2007, for example, the United States District Court for the Northern District of Ohio, Western Division, held that the signing of

66. *In re* Cabletron Systems, Inc., 311 F.3d 11, 39 (1st Cir. 2002) (holding that motive and opportunity alone are not sufficient to plead scienter without a combination of facts and circumstances indicating fraudulent intent); *see also* Ottmann v. Hanger Orthopedic Group, 353 F.3d 338, 345 (4th Cir. 2003); Abrams v. Baker Hughes, Inc., 292 F.3d 424, 438 (5th Cir. 2002); Helwig v. Vencor, Inc., 251 F.3d 540, 551 (6th Cir. 2001); Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 601 (7th Cir. 2006); *In re* Navarre Corp. Sec. Litig., 299 F.3d 735, 747-48 (8th Cir. 2002); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1249 (10th Cir. 2001); *Bryant*, 187 F.3d at 1285.

67. Joseph A. Grundfest & A.C. Pritchard, *Statues with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 678 (2002).

> District court judges who interpret the "strong inference" provision generate aggregate patterns of behavior that are, to a remarkable degree, statistically indistinguishable from a "coin-toss" model of judicial behavior. In this coin-toss model, the judge first flips a coin to determine whether the Second Circuit standard prevails or whether Congress intended to adopt a more stringent standard. If a more stringent standard applies then the judge tosses the coin again to decide between the Intermediate standard and the Ninth Circuit standard.

Id.

68. *Id.*

SOX certification reports by the CEO and board chairman, which contained financial mistakes that ultimately had a "large impact" on the value of the corporation's shares, was insufficient to plead scienter without a showing that the reports were "intentionally misleading."[69] The court arrived at this holding despite the facts that: (i) over a period of approximately 18 months, the corporation's income had been overstated by as much as 70%, (ii) the corporation actually lost $1.27 billion instead of earning approximately $920 million as previously reported, and (iii) the corporation filed for bankruptcy while the chairman announced his retirement and the CEO received a generous bonus to stay on and guide the corporation through bankruptcy.[70]

In March 2007, the Northern District Court of California went a step further and held that a SOX certification containing false declarations that financial statements comply with generally accepted accounting principles is not independently actionable under Section 10(b) or Rule 10b-5 but may be used merely as an "inference of scienter."[71] In fact, the court in that case noted that there was "nothing in either the 1934 Securities Exchange Act or the Sarbanes-Oxley Act and implementing regulations that authorizes plaintiffs to base a claim for securities fraud on an alleged misstatement in a Sarbanes-Oxley certification."[72]

In an even more troubling case, the District Court for the District of Colorado not only avoided answering the scienter question, but also declared that Sections 302 and 906 of SOX do not even grant parties a private right of action against corporate officers.[73] In *Srebnik v. Dean*, a group of shareholders brought an action pursuant to Sections 302 and 906 of SOX against several officers of Miller Diversified Corp., a cattle feedlot public company in Colorado, and Anderson & Whitney, the corporation's auditors and preparers of the proxy statement relating to an unlawful and fraudulent acquisition of business assets. The defendants were accused of submitting false SOX certifications to the SEC and of "loot[ing] assets through concealed off-the-books payments, sham loans and other bogus transactions including the fraudulent acquisition of a

69. Frank v. Dana Corp., 525 F. Supp. 2d 922, 930 (N.D. Ohio 2007).
70. *Id.* at 926.
71. *See In re* Silicon Storage Tech., Inc. Sec. Litig., 2007 U.S. Dist. LEXIS 21953, at *52 (N.D. Calif. 2007).
72. *Id.* at *51.
73. Srebnik v. Dean, 2006 U.S. Dist. LEXIS 73836, at *19 (Colo. 2006).

business for a promissory note issued by an insolvent company."[74] Surprisingly, the court dismissed the shareholders' complaint, stating that there was no judicial authority addressing the availability of a private right of action under Sections 302 and 906 of SOX[75] and that the text of these sections "do not contain any 'rights creating' language or other indication that Congress intended to create a private right of action in favor of a class of shareholders for violations of these provisions."[76]

Conversely, one Louisiana District Court in December 2006 pointed out that there was only one case in which a District Court (in Oregon) found that a certification executed by a corporate officer pursuant to Section 302 of SOX supports an inference of scienter against the certifying defendant.[77] In *In re Lattice Semiconductor Corp.*, that court elaborated on its analysis of whether certification alone supports scienter by noting that some commentators have argued that:

> when a corporate officer certifies a company's financial reports, the company's later revelation that the reports contained material false statements can support an inference that the officer either knew or was reckless about the false statements, by virtue of the company's disclosure controls, or that he knew or was reckless in not knowing that the company's disclosure controls were inadequate.[78]

In the end, however, the Louisiana court held that SOX certifications, alone, would not support a strong enough inference of scienter.[79]

What did this jumble of inconsistent precedents mean for litigants? At the narrowest level, these cases suggested that the questions presented by the "strong inference" debate were ripe for Supreme Court review in order to resolve the split among the circuits and hopefully eliminate the divergence in the district courts. A Supreme Court decision, it was hoped, could establish a consistent nationwide interpretation of the "strong inference" standard.

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74. *Id.* at *5.
75. *Id.* at *17.
76. *Id.* at *18.
77. *In re* OCA, Inc. Sec. and Derivative Litig., 2006 U.S. Dist. LEXIS 90854, at *72 (D. La. 2006) (citing *In re* Lattice Semiconductor Corp. Sec. Litig., 2006 U.S. Dist. LEXIS 262 (D. Or. 2006)).
78. *Id.* at *74.
79. *Id.* at *75.

III. THE U. S. SUPREME COURT WEIGHS IN WITH ITS DECISION IN *TELLABS, INC. V. MAKOR ISSUES AND RIGHTS*

Despite the split in the Circuits, it is clear that some form of fraudulent intent is required. In order to clarify this issue for all litigants, regardless of jurisdiction, the Supreme Court declared that a mental state embracing intent to deceive, manipulate or defraud is an essential element of a Section 10(b) or Rule 10b-5 claim.[80] In essence, a plaintiff-shareholder must set forth facts in support of his allegations of fraud, as well as provide support for allegations of the required state of mind – that is, facts creating a strong inference of scienter.[81] On June 21, 2007, the Supreme Court further addressed how to treat an examination of the pleading requirements in a Section 10(b) and Rule 10b-5 action and specifically how to define a "strong inference" of scienter.[82] In *Tellabs, Inc.*, the Court held that when determining the existence of a strong inference of scienter, courts must consider the complaint in its entirety, as well as documents incorporated into the complaint by reference (such as SOX certifications) and should conclude that an inference of scienter has as much plausibility as inferences to the contrary.[83] That is, when the allegations of fraud are accepted as true and taken collectively, a reasonable person must deem the inference of scienter at least as strong as any opposing inference.[84] Thus, the inference of scienter must be cogent and compelling in light of other explanations.

Tellabs is a manufacturer of specialized equipment for fiber optic networks.[85] The shareholders of Tellabs alleged that Richard Notebaert, the CEO and president, engaged in a scheme to deceive investors about the true value of Tellabs stock.[86] Notebaert was accused of: (1) falsely asserting in January of 2001 that the demand for the company's flagship networking device was continuing to grow, (2) stating that the company's financial results were stronger than they actually were, and (3) grossly overstating revenue projections.[87] In a December 2000 press release, Notebaert had declared that Tellabs had "record sales and

80. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).
81. Helwig v. Vencor, Inc., 251 F.3d 540, 565 (6th Cir. 2001).
82. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509 (2007).
83. *Id.* at 2509-10.
84. *Id.* at 2511.
85. *Id.* at 2505.
86. *Id.*
87. *Id.*

earnings in the fourth quarter of 2000," and announced that "customers are buying more and more Tellabs equipment."[88] Notebaert later informed financial analysts that Tellabs had "set the stage for sustained growth with the successful launches of several products," and in January of 2001 he further elaborated that demand for their latest product, the TITAN 6500, was exceeding expectations and that they felt "very, very good about the robust growth we're experiencing."[89]

Later, in February of 2001, a letter signed by Notebaert was sent to stockholders wherein it was stated that Tellabs's growth was robust, its markets held significant potential for sustained growth, its core business was performing well, and that sales of the TITAN 6500 were up 56% in 2000.[90] The first sign of trouble appeared in March of 2001 when Tellabs unexpectedly reduced its first quarter sales projections. Simultaneously, however, Notebaert reiterated the company's positive forecasts by declaring that demand for its core products remained strong.[91] This pattern of reducing sales projections while announcing strong interest in products continued for several months. Finally, on June 19, 2001, Tellabs announced that projected sales for the second quarter would be almost $300 million less than originally projected.[92] The next day, Tellabs' stock price plummeted from $38 a share to $15.87 a share.[93] This drop was on top of the initial drop in stock price from $67 that occurred around March of 2001.[94] In a five-month span, therefore, the stock price went from $67 to $15.87 a share. In December of 2002, shareholders filed suit against Tellabs and ten executives in the District Court for the Northern District of Illinois.[95] The complaint alleged that Tellabs stock was artificially inflated causing market analysts to continue to recommend that investors buy that stock.[96] The complaint was dismissed on several grounds, including a finding that "the complaint failed to adequately allege that the defendants' conduct met the scienter

88. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 592 (7th Cir. 2006).

89. *Id.*

90. *Id.*

91. *Id.* at 593.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2505 (2007).

standard for securities fraud, which requires that they intended 'to deceive, manipulate, or defraud.'"[97]

"In July of 2003, the plaintiffs filed a second amended complaint, bolstering their allegations with references to 27 confidential sources, shortening the list of defendants by four, eliminating a few of their weaker claims, and adding more specific scienter allegations against each of the remaining defendants."[98] After the District Court again dismissed the complaint, the shareholders appealed to the Seventh Circuit Court of Appeals which reversed in part, finding that the shareholders "had pleaded the misleading character of Notebaert's statements with sufficient particularity."[99] Unfortunately for the plaintiffs, however, the Seventh Circuit also determined that they had failed to allege that Notebaert acted with scienter.[100] The shareholders then appealed to the United States Supreme Court.

Writing for the majority, Justice Ginsburg established a three-part test for evaluating a Rule 12(b)(6) motion to dismiss a securities fraud claim. First, courts must "accept all factual allegations in the complaint as true."[101] Second, courts should not scrutinize any individual allegation in isolation, but rather should "consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice."[102] Justice Ginsburg reiterated that the analysis must be of "all of the facts alleged, taken collectively" to determine if there is a strong inference of scienter.[103] Third, in making that determination of whether "the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences."[104] Justice Ginsburg further articulated this three-part analysis by stating that "the strength of an inference cannot be decided in a vacuum."[105] Instead, a court must consider "nonculpable explanations for the defend-

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97. *Makor Issues*, 437 F.3d at 593 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).
98. *Id.* at 594; *see also Tellabs*, 127 S. Ct. at 2506.
99. *Tellabs*, 127 S. Ct. at 2506 (citing *Makor Issues*, 437 F.3d at 595-600).
100. *Id.* at 2509.
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.* at 2510.

ant's conduct, as well as inferences favoring the plaintiff."[106] Some may argue that the majority was attempting to swing the pendulum back toward the plaintiffs; Justice Ginsburg pointed out that the inference set forth by the plaintiffs need not be of the "smoking gun" nature or even "the most plausible of competing interests."[107] Rather, the Court held that a complaint would be defeated by a motion to dismiss unless "a reasonable person would deem the inference of scienter cogent and *at least as compelling as any opposing inference* one could draw from the facts alleged."[108]

In a nutshell, the Supreme Court instructed lower courts to accept the allegations set forth in the complaint as true, and then determine if a reasonable person would find that the inference of scienter is at least as strong as any competing interest. Thus, "if the answer to this analysis is no, then the inference is not 'strong' under the PSLRA."[109]

In reality, the decision in *Tellabs* "strengthens the pleading standard set forth by Congress in the PSLRA, and creates a uniformly high bar for pleading scienter in securities fraud cases."[110] As a result, the *Tellabs* case further supports the existing hurdles erected to make it difficult for plaintiffs who hope to sustain a securities fraud claim.

Thus, after *Tellabs*, practitioners and scholars must acknowledge that perhaps forcing top executives to certify regulatory filings pursuant to SOX is not quite the solution to the corporate financial scandal problem that Congress or investors had hoped for. The certification requirement may still be a powerful incentive for corporate executives to do the right thing, but its power is diminished by the additional requirement that a plaintiff must still establish a strong inference of scienter at the pleading stage. Thus, the certification requirement alone is not the sharp veil piercing tool it was originally thought to be. The requirement that an officer sign a certification form will likely work to deter some, but not others. In fact, many lawyers have been advising executives not to

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106. *Id.*

107. *Id.*

108. *Id.* (emphasis added).

109. JONATHAN C. DICKEY, PRACTISING LAW INST., SECURITIES LITIGATION AND ENFORCEMENT INSTITUTE 2007: CURRENT TRENDS IN FEDERAL SECURITIES LITIGATION 28 (Oct. 15, 2007), *available at* http://www.gibsondunn.com/publications/Documents/Dickey-SecuritiesLitigationAndEnforcementInstitute2007.pdf.

110. *Id.* at 30.

focus too much on the certification requirement, "telling them that it's not a new and unique liability that's been imposed."[111]

As for the concern over the apparent increase in exposure to claims faced by auditing firms, there seems to be less of a cause for alarm than originally feared. With the exception of Arthur Andersen, the number of class actions against auditing firms has actually decreased in the past two years.[112] Simultaneously, those claims that have been initiated have largely been dismissed due to the heightened pleading standards established under the PSLRA.[113] It appears that there is no greater risk faced by auditors than that faced by corporate executives.

IV. A LOOK AT THE RECENT TREND TO PROVIDE ADDITIONAL PROTECTIONS FOR CORPORATIONS, THEIR OFFICERS/DIRECTORS, AND AUDITING FIRMS

"For the first time since [Sarbanes-Oxley] was enacted in 2001, there seems to be mounting concern that the pendulum has swung too far towards 'over regulation' in the wake of the collapse of Enron, Worldcom, Adelphia, and other companies . . . ."[114] Despite the difficulties faced by litigants who attempt to pierce the corporate veil with the dull sword provided by Sarbanes-Oxley, some industry groups are taking a look at the current legislation and are drafting proposals to provide corporations and accounting firms with a new shield against both criminal penalties and civil lawsuits. As noted in one article in the *New York Times*, "two influential industry groups . . . are hoping to swing the regulatory pendulum in the opposite direction."[115] The aim of these groups appears to be threefold: (1) to limit the liability of accounting firms; (2) to reduce the number of lawsuits brought by shareholders; and, (3) to narrow the focus of prosecutors toward the

111. *See* Glater, *supra* note 14, at 5.

112. Gideon, *Accounting Fraud*, *supra* note 60, at 1104 (noting that class action filings in 2006 declined 38% from 2005 and were 43% lower than the 10-year average).

113. *See* Ezra Charitable Trust v. Tyco Int'l, Ltd., 466 F.3d 1, 33 (1st Cir. 2006) (dismissing the claims against PricewaterhouseCoopers and holding that the accounting restatements were not enough to establish scienter under the PSLRA pleading requirements).

114. DICKEY, *supra* note 109, at 2.

115. Stephen Labaton, *Businesses Seek New Protection on Legal Front*, N.Y. TIMES, Oct. 29, 2006, at 1.

individual violators instead of prosecuting whole companies.[116] In addition, these groups aim to reduce the burdens imposed by Sarbanes-Oxley and to provide the SEC with broader discretion on the interpretation and enforcement fronts. Support has grown for these proposals – particularly after the Supreme Court overturned the obstruction of justice conviction of Arthur Andersen in connection with its shredding of Enron-related documents.[117]

The vindication of Arthur Andersen came too late to save the firm from collapse, but it did prompt commentators to acknowledge that preemptively limiting the exposure for auditing firms, and corporations in general, would make the likelihood of a future major accounting firm collapse significantly less likely. Some of the reforms that are being considered which are specifically aimed at protecting accounting include: (1) creating safe harbors for certain defined auditing practices,[118] (2) setting a cap on auditor liability in certain circumstances, and clarifying and limiting auditor's duties under Section 10A,[119] (3) restricting criminal penalties against firms as opposed to individual auditing partners,[120] and (4) granting regulators specific powers to appoint monitors to oversee operations of audit firms found to have engaged in systematic failures in process, management, or personnel.[121]

As noted by Conrad Hewitt, Chief Accountant for the SEC, accounting firms are the final target in many of these lawsuits because the company at issue no longer has the resources to satisfy a judgment.[122] Hewitt also noted that:

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116. *Id.*

117. *Id.*

118. *See* Stephen Labaton, *S.E.C. Seeks to Curtail Investor Suits*, N.Y. TIMES, Feb. 13, 2007, at C1 (discussing the SEC's plans to protect corporations, executives, and accounting firms from investor lawsuits).

119. *Id.*; Conrad Hewitt, Chief Accountant, U.S. Secs. & Exch. Comm'n, Remarks to the Practising Law Institute's SEC Speaks Series (Feb. 9, 2007), *available at* http://www.sec.gov./news/speech/2007/spch020907cwh.htm.

120. Labaton, *supra* note 115.

121. Jonathan C. Dickey, *Auditor Liability "Caps" – The Politics of Catastrophe*, 5 SEC. LITIG. REP. 5 (Nov. 2008), *available at* http://www.gibsondunn.com/publications/Documents/Dickey-AuditorLiabilityCaps.pdf (citing the Paulson Committee Report).

122. *See* Hewitt, *supra* note 119 (stating that large accounting firms are often the "deep pocket" litigants pursue to recover losses).

> the issue does not appear to be the number of meritless lawsuits that are filed, but the fact that potential claims against major accounting firms can be so large that a judgment in any one case might force a firm into bankruptcy and result in further consolidation of the audit profession with fewer firms.[123]

He concluded by suggesting that the accounting profession propose to Congress that reasonable limits be placed on auditing firms' exposure to liability for violations of federal securities regulations, in much the same way liability has been limited for other professions in the U.S. and in Europe[124].

Commentators have also proposed changes that would direct prosecutors to seek redress from the individuals actually responsible for the securities violations rather than corporations as a whole.[125] While on first blush this may seem appealing, a persuasive opposing argument exists; in large corporations it is often very difficult for prosecutors and shareholders to ferret out evidence that pinpoints the specific persons involved with the fraudulent activities.

Responding to these arguments, SOX proponents counter that the proposed reforms are misguided responses to a false alarm. According to some studies, SOX has not had the effect of significantly increasingly the number of securities claims.[126] Such results suggest that there does not appear to be a need to loosen regulation. Moreover, opponents of the groups seeking SOX revisions believe certain suggested revisions would "dramatically diminish the effectiveness of the S.E.C., of criminal enforcement, of state attorney general enforcement, and of private damage actions . . . ."[127]

However, in the author's view, some of the groups' proposals to amend SOX do have merit. Proposals seeking to direct certain disputes to arbitration, or to judges rather than juries, and limiting the liability of accounting firms to prevent further shrinkage in the industry have some validity and warrant further investigation.

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123. *Id.*

124. *Id.*; *see infra* Section V.

125. Labaton, *supra* note 115.

126. Roger Russell, *Facing the Storm: Planning and SOX Worrying Insurers*, ACCOUNTING TODAY, July 26, 2004 – Aug. 8, 2004 (quoting Ken Mackunis, president of Aon Insurance Services, the administrator for the American Institute of CPAs Professional Liability Insurance Program).

127. *See* Floyd Norris & Stephen Labaton, *Panel Urging Rewriting Rules to Aid Companies*, N.Y. TIMES, Nov. 30, 2006, at 2.

V. HOW HAS EUROPE HANDLED SECURITIES FRAUD ISSUES?

In light of the challenges facing lawmakers, corporate officers, and accounting firms in the United States, it is relevant to consider how these issues are being dealt with abroad. In Europe, the debate has been focused on the accounting industry and the risks posed to it by excessive and burdensome litigation. Indeed, experts in the United States concur and have expressed concern over the severity of this issue. In particular, the collapse of Arthur Andersen has provoked major worldwide concern over the status of the accounting industry. A recent spate of studies and reports express concern over the fragile state of the Industry and of the remaining "Big Four" firms that dominate it.[128] The number of barriers to entry facing mid-sized auditing firms diminishes the likelihood that new competition will challenge these four major firms.[129] Meanwhile, even the "Big Four" are finding it difficult to endure while laboring under the constant risk of potentially fatal litigation.[130] One study reports that "[t]he profession is already viewed as increasingly less attractive and risky . . . ." and that "[a] major claim that threatens the survival of a firm would simply reinforce the negative perceptions about the profession."[131] Further, experts predict that the collapse of one or more of the "Big Four" firms could have catastrophic consequences for capital markets.[132]

In response to this problem, countries in the European Union have begun debating the merits of widespread caps on auditor liability. Under a liability cap, the possible recovery against auditing firms would be limited either to a fixed amount, or by a formula that takes into account

128. DIRECTORATE GEN. FOR INTERNAL MKT. & SERVS., CONSULTATION ON AUDITORS' LIABILITY AND ITS IMPACT ON THE EUROPEAN CAPITAL MARKETS (COMMISION STAFF WORKING PAPER, Jan. 2007), *available at* http://ec.europa.eu/internal_market/auditing/docs/liability/consultation-paper_en.pdf [hereinafter COMMISSION PAPER].

129. *Id.* at 8-9.

130. *Id.* at 9.

131. *See* LONDON ECONOMICS, STUDY ON THE ECONOMIC IMPACT OF AUDITORS' LIABILITY REGIMES 209-10 (Sept. 2006), *available at* http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf [hereinafter LONDON ECONOMICS STUDY].

132. AccountingWEB.co.uk, EU Audit Liability Cap Looks Likely, http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=169456&d=1025&h=1024&f=1026 (last visited Jan. 18, 2009).

certain factors.[133] Proponents put forth several different policies that would be advanced by capping liability. Major policy rationales include: protecting capital markets from the potentially devastating collapse of a major auditing firm,[134] lowering the barriers to entry for competition by middle-tier firms,[135] and making the size of future claims more predictable so as to improve the insurability of audit activity.[136] Additionally, such caps may help prevent the "deepest pockets" syndrome described by Hewitt.[137] This occurs when plaintiffs, seeking a large recovery, shift liability onto the auditing firm even when it may be responsible for only a small portion of the wrongdoing.[138] Of course, liability caps are not without their critics, who claim that such caps may reduce the quality of audits.[139]

A recent European Commission Working Paper contained several methods of remedying the problem of over-litigation, listing as the most straightforward method the imposition of an *absolute* cap on auditor liability.[140] This approach has already been employed in some countries, and is relatively simple: it imposes a fixed monetary cap on the recovery that may be sought by an injured plaintiff against an auditing firm.[141] This "one size fits all" approach is inflexible, however, and it would be difficult to calculate the exact level at which to cap liability.[142] A modified version of this approach could help alleviate some of these drawbacks by offering a *variable* cap on liability. For example, the cap could be set according to the size of the company being audited[143] or by the fees that the auditing firm charges the company.[144]

133. *Id.*

134. LONDON ECONOMICS STUDY, *supra* note 131, at 185.

135. *Id.*

136. *Id.*

137. COMMISSION PAPER, *supra* note 128, at 7; *see* Hewitt, *supra* note 119.

138. LONDON ECONOMICS STUDY, *supra* note 131, at 186; COMMISSION PAPER, *supra* note 128, at 7.

139. Penny Sukhraj, *Big Four Gains Support on Liability Argument*, ACCOUNTANCY AGE, Oct. 12, 2006.

140. COMMISSION PAPER, *supra* note 128, at 12.

141. *Id.*

142. *Id.* ("If such a cap were set too high, mid-tier audit firms would be further disadvantaged. If, on the other hand, the cap were set too low, this might have a negative impact on the quality for the audit of major listed companies.").

143. *Id.* at 12-13 (noting that this offers the advantage of alleviating the burden on mid-sized accounting firms, thus promoting competition).

144. *Id.* at 13.

Finally, an alternative approach would be to implement a policy of proportionate liability, limiting the auditor's damages to those caused by their own mistakes and not the mistakes of their clients.[145] This would run counter to the usual system of joint and several liability, whereby auditing firms may "bear a portion of the charges resulting from the misconduct of the audited company, in particular if that company goes bankrupt."[146] Instead, under the proportional liability method, courts could allocate damages according to the portion of fault attributed to the auditing company, or allow auditing firms and their clients to work out contractual agreements specifying the proportion of liability.[147] On the downside, this method of apportioning damage may seem less transparent to the public than simply setting a clearly defined cap on liability.[148] Nonetheless, out of all these methods, the proportionate liability option has gained support even amongst skeptics of liability capping.[149] Furthermore, it is possible to imagine a combination of these approaches, such as layering a variable cap on top of a proportionate liability system. Although the U.S. has adopted a system of proportionate liability, auditors are still offered less protection than in the European Union, due to the United States' allowance of punitive damages.[150]

Currently, five European countries impose a liability cap on auditing firms: Austria, Belgium, Germany, Greece, and Slovenia.[151] Though the amount and nature of the caps vary among each country, they all impose a limit on the liability of auditing firms.[152] In an effort to exam-

145. *Id.*

146. *Id.* at 4.

147. *Id.* at 13.

148. *Id.* at 12 ("A variable cap would be more transparent . . . as compared with proportionate liability.").

149. Letter from Ondrej Petr, Regulatory Policy – Primary Mkts., Int'l Capital Mkt. Ass'n, to Jim Bellingham, Corporate Law & Governance Directorate, Dep't of Trade & Indus. 2 (May 30, 2007), *available at* http://www.icma-group.org/getdoc/51ac14c2-01c2-401d-9f00-6c2e22fcdd2b/ICMA-Response-to-DTI-CP-re-Statutory-Audit-Directi.aspx ("[W]e find proportionate liability (rather than fixed liability caps) the least problematic solution . . . .").

150. COMMISSION PAPER, *supra* note 128, at 7-8.

151. LONDON ECONOMICS STUDY, *supra* note 131, at 153.

152. Slovenia sets the liability at a steady €150,000; Greece sets the liability at "Five times the total of the annual emoluments of the President of the Supreme Court or the total of the fees of the liable Certified Auditor in the previous financial year provided that the latter exceeded the former limit"; Austria sets the limit based on the size of auditing firm; Belgium and Germany set the liability according to whether the auditing

ine how empirically successful these liability caps are in advancing the aforementioned policies, the London School of Economics conducted a study which compared the results of countries with liability caps to those without such caps.[153] The study analyzed several different criteria and came up with many relevant conclusions:

- In some circumstances, the cost of unlimited liability may outweigh the benefits.[154]
- Audit quality is not adversely affected by the presence of liability caps.[155]
- According to auditing firms polled, firms in countries with unlimited liability schemes find it harder to recruit and retain qualified talent.[156] These firms also feel that unlimited liability reduces their ability to supply the audit market.[157]
- Liability caps may help increase competition by the lowering the barriers to competition facing middle-tier firms.[158]

Finally, two additional points are worthy of mention. First, the study found that, according to the data available, comparisons of countries with liability caps and those without liability caps showed no significant difference in the average dollar amount of recovery on claims.[159] The reason is that, in countries that cap liability, the cap only applies to *negligent* conduct.[160] That is, that cap may be disregarded where the auditor's conduct is found to be intentional or grossly negligent. This has resulted in many plaintiffs alleging intentional wrongdoing or fraud, in an attempt to get a higher recovery or settle-

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firm is listed or unlisted. *See* LONDON ECONOMICS STUDY, *supra* note 131, at 187-88.

153. LONDON ECONOMICS STUDY, *supra* note 131, at 164-65.

154. *Id.* at 177 ("[U]nlimited liability may in certain cases imply that the costs of unlimited liability exceed the benefits from a welfare point of view.").

155. *Id.* at 158 ("[W]e conclude that audit quality, as proxied by accruals management, does not appear to be significantly affected by the existence of a cap.").

156. *Id.* at 176.

157. *Id.* at 180 ("Overall, the unlimited liability regime is perceived as having a potentially significant impact on the capacity of firms to supply the audit market.").

158. *Id.* at 164 ("This suggests that the existence of an auditor liability cap may help middle-tier firms break into the market segment that is largely dominated by the Big-4 firms in many countries. The very small size of the sample with an auditor liability cap, however, does not allow one to draw strong inferences from the data.").

159. *Id.* at 159.

160. *Id.*

ment.[161] Thus, liability caps can still be circumvented to some extent, depending on the plaintiff's pleading. Second, the study also states that "parties seeking compensation for a loss . . . are likely to seek greater compensation from directors and officers when the auditor's liability is limited."[162] These points show that even where auditor liability is capped in some way, the larger issues of pleading requirements and veil piercing still must be addressed.

CONCLUSION

While post-Enron legislation and regulation, namely Sarbanes-Oxley, was intended to change the complexion of professional liability for corporate officers and accountants alike, in reality, there hasn't been a major shift in claim activity.[163] In fact, rather than rectify the crisis of confidence in U.S. corporate governance and financial reporting, Sarbanes-Oxley has actually created a number of gray areas in its interpretation which has led to legal experts, auditors, and corporate executives searching for some solid guidance and alternative solutions.[164] Moreover, it appears that even when a corporate officer submits a fraudulent certification to the SEC, the false certification alone will not be sufficient to establish scienter and to pierce the corporate veil. Now that the Supreme Court has resolved the split in the Circuit Courts of Appeal on the issue of what is a "strong inference of scienter" in *Tellabs*, it is time to resolve the issue currently making its way through the federal District Courts – the issue of whether signing a false Section 302 certification provision is enough to establish scienter and to survive the pleading stage. While some industry groups seek to "swing the pendulum back" to less federal oversight and more self-regulation, the ability of individual investors to hold a CEO's and CFO's feet to the fire for his false financial certifications seems to not be the panacea initially foreseen by members of the legislature and investors. Despite the codification of personal liability provisions such as Sections 302 and 906 of SOX, it appears that litigants must still leap the high hurdle of demonstrating a strong inference of scienter – the same requirement established long before SOX – in order to pierce the corporate veil and hold those

161. *Id.*
162. *Id.* at 196.
163. *See* Russell, *supra* note 126.
164. Ghoshray, *supra* note 57, at 488.

officers who committed fraud responsible for the devastation their actions have caused.

First, Congress must revisit the language it used in Sections 302 and 906 and amend the statute to specifically provide that a CEO's or CFO's signature on a fraudulent certification *does* establish a strong inference of scienter. Leaving this evaluation to the courts on a case-by-case basis will only expand the myriad of interpretations employed by the federal district courts and will exacerbate the inconsistency that already exists on the issue. As discussed above, despite the fact that the Supreme Court has provided the framework for defining a "strong inference" of scienter in the *Tellabs* case, the federal district courts are still "all over the map" on the issue of whether fraudulent certifications alone establish that inference. The certification provisions were included for the express purpose of exposing CEOs and CFOs to personal liability, based on the fact that these officers are supposed to be certifying that the information contained in the financial statements to the SEC is accurate and true.[165] Therefore, in the view of the author, when the certified documents contain fraudulent information, the certification should absolutely be interpreted as providing a strong inference of scienter.

Next, Congress should consider employing a hybrid of the European methods for handling auditor liability by creating a variable cap that slides up or down based on the auditing company's size and/or fees, while simultaneously providing a ceiling above which no litigant can recover against the auditing company. These caps should be specifically applied to situations of negligence; all caps should be removed for instances of intentional wrongdoing or grossly negligent conduct on the part of the auditors. This would hopefully provide some security for the continued viability of the "Big Four" and will also remove some of the barriers to future growth in the industry.

By implementing the above two suggestions, Congress will loosen the restraints for litigants to get to the executives who are essentially the "head" of the securities fraud monster, while simultaneously limiting the exposure of auditing firms. These proposals listed above would thereby accomplish two goals: (1) to re-sharpen the blade on the SOX sword, enabling litigants to pierce the corporate veil and to reach those exec-

165. *See* Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1350 (2002) (subjecting officers who intentionally make false Section 906 certifications to up to $5 million in fines and twenty years in prison).

utives who are directly responsible for the fraudulent schemes that have devastated the financial markets in recent years; and, (2) to place some limitations on the liability of the accounting firms, with the hope that the capped liability will still remain a sufficient incentive to operate up to ethical and regulatory standards, while providing the framework to inject some stability into the industry.