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## Securities Fraud, Officer and Director Bars, and the “Unfitness” Inquiry after Sarbanes-Oxley

Jon Carlson\*

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## NOTE

### SECURITIES FRAUD, OFFICER AND DIRECTOR BARS, AND THE “UNFITNESS” INQUIRY AFTER SARBANES-OXLEY

*Jon Carlson\**

#### INTRODUCTION

In early 1988, Ratilal Patel and Dilip Shah were executives of two successful and related pharmaceutical companies.<sup>1</sup> Patel was a founder, director, and officer of Par Pharmaceuticals; Shah was the president of Par’s subsidiary Quad Pharmaceuticals.<sup>2</sup> Par and Quad were rising stars in the generic drug industry, and long-term investors in Par were undoubtedly delighted by the steady gains in the company’s stock price.<sup>3</sup> In the summer of 2008, however, the good times came to an abrupt end when federal prosecutors indicted Patel and Shah for their roles in bribing and defrauding the Food and Drug Administration (“FDA”), acts that had resulted in the distribution of untested and unapproved versions of the companies’ drugs to consumers.<sup>4</sup> The market for Par stock

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\* J.D. Candidate, 2009, Fordham University School of Law. I would like to thank Professor Caroline Gentile for her guidance and encouragement during the Note-writing process.

1. SEC v. Patel, 61 F.3d 137, 138 (2d Cir. 1995); SEC v. Patel, No. 93 Civ. 4603, 1994 WL 364089, at \*1 (S.D.N.Y. July 13, 1994); SEC v. Shah, No. 92 Civ. 1952, 1993 WL 288285, at \*1 (S.D.N.Y. July 28, 1993).

2. *Patel*, 61 F.3d at 138; *Shah*, 1993 WL 288285, at \*1.

3. See Yahoo! Finance, Historical Prices, Par Pharm. Cos., Inc. (PRX), <http://finance.yahoo.com/q/hp?s=PRX&a=11&b=30&c=1987&d=00&e=2&f=2009&g=d&z=66&y=5214> (last visited Feb. 23, 2009) (listing historical daily closing price of Par stock from Dec. 1987 – Mar. 1988).

4. *Patel*, 61 F.3d at 138; *Patel*, 1994 WL 364089, at \*1; *Shah*, 1993 WL 288285, at \*2. Though Shah and Patel were only charged with bribing a public official, their scheme also may have violated the Federal Food, Drug, and Cosmetic Act. The shipping of adulterated or mislabeled food or drugs is a serious offense, and managers of

reacted swiftly: the price dropped from \$17.37 to \$10.12 in the course of three months.<sup>5</sup>

The scandal went far beyond what prosecutors initially thought had occurred. Not only had Shah and Patel sabotaged the mechanisms that were designed to ensure the safety of their drugs, they had also begun selling their Par stock prior to the public announcement of their misconduct with the FDA.<sup>6</sup> Consequently, the Securities and Exchange Commission ("SEC") sued, alleging fraud, and sought to have both men permanently barred from serving as managers of any publicly traded company.<sup>7</sup> In both cases, however, the courts ultimately held that the managers' misconduct did not justify such a remedy.<sup>8</sup>

At this moment, Shah and Patel may be in a boardroom, managing a company owned by widely dispersed members of the public. Why would any rational person invest in a company run by someone like Shah or Patel? In some cases, public investors have no meaningful choice in the matter because they do not know of the current management's prior wrongdoing.<sup>9</sup> In other cases, shareholders are the direct beneficiaries of corporate misconduct and thus have no incentive to oust misbehaving management.<sup>10</sup> Why would the government allow such a person to continue serving in a position of public trust? Simply put, it does not allow it.<sup>11</sup>

For many years, the SEC has sought to bar corporate managers and others whose illegal misconduct shows contempt or disregard for the nation's scheme of securities regulation.<sup>12</sup> Federal securities regulation is

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corporations charged with such a violation can be held strictly liable. *See* United States v. Park, 421 U.S. 658, 671 (1975) (discussing the case law's position that managers must be held accountable and holding CEO strictly liable for the company's violation of the Federal Food, Drug, and Cosmetic Act).

5. On July 13, 1988, the stock closed at \$17.375. *Shah*, 1993 WL 288285, at \*2. By October 24, 1988, the price had fallen to \$10.12, with sharp declines occurring as more negative press was released. *Id.* The price fell to \$7.125 by July 25, 1989. *Patel*, 61 F.3d at 139.

6. *Patel*, 1994 WL 364089, at \*1; *Shah*, 1993 WL 288285, at \*1.

7. *Patel*, 1994 WL 364089, at \*1-2; *Shah*, 1993 WL 288285, at \*3.

8. *Patel*, 61 F.3d at 142; *Shah*, 1993 WL 288285, at \*7.

9. Dispersed shareholders may also lack the control necessary to oust a violating manager once they have learned of the violation. S. REP. NO. 101-337, at 18 (1990).

10. *Id.*

11. Securities Act of 1933, 15 U.S.C. § 77t(e) (2008); Securities Exchange Act of 1934, 15 U.S.C. § 78(u)(d)(2) (2008).

12. *See* H.R. Rep. No. 101-616, at 31-32 (1990), as reprinted in 1990

designed to promote free and efficient capital markets by ensuring that up-to-date information flows freely from corporate issuers to the public.<sup>13</sup> By introducing untrue or misleading information into the market, fraud undermines this freedom and efficiency.<sup>14</sup> Securities fraud is a serious violation and violators are subject to a variety of securities law sanctions, including monetary penalties, disgorgement, occupational bars, and imprisonment.<sup>15</sup> The SEC has used the officer and director bar particularly to prevent perpetrators of fraud from serving as fiduciaries to the public.<sup>16</sup>

This Note examines the federal courts' inconsistent and problematic interpretations of the officer and director bar statutes and proposes a solution that satisfies Congress's intent and that is fair both to the SEC and to the defendants in enforcement proceedings. Part I reviews the history of the officer and director bar as a remedy for securities fraud violations. It concludes by explaining how Congress responded to cases like *Shah* and *Patel* in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). Part II categorizes and discusses the various approaches that federal courts have taken in interpreting and applying the officer and director bar after Congress amended the bar statutes in Sarbanes-Oxley. So far, few courts have demonstrated a clear understanding of the amended statutes. Part III draws from the history of the officer and director bar, including the events leading up to the passage of Sarbanes-Oxley, to propose a solution that is consistent with the legislative purpose of the amended statutes and the past seventy years of securities enforcement.

## I.

The officer and director bar has had a tortuous history in both federal legislation and the courts. Knowledge of this history is essential to

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U.S.C.C.A.N. 1379, 1394-95.

13. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 36-38 (5th ed. 2004) (explaining how the "disclosure philosophy" of securities regulation came to be the scheme embodied in the federal securities laws).

14. See, e.g., Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119, 147 (2002).

15. See generally Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) [hereinafter Remedies Act] (providing examples of stated remedies for instances of fraud).

16. H.R. REP. NO.101-616, at 13 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1380.

understanding the meaning of the most recent amendment to the officer and director bar statutes.<sup>17</sup>

### A. Injunction

The director and officer bar originated as a form of injunctive relief for violations of the securities laws. Prior to 1984, the only remedy expressly provided for such violations was an injunction against future violations.<sup>18</sup> The first courts to issue officer and director bars did so by fashioning injunctions that specifically prohibited defendants from further service as corporate executives.<sup>19</sup> The significance of the bar's origin is more than historical: the legal standards for and limitations on imposing injunctive relief continue to be influential in defining the reach of the modern officer and director bar.

Generally speaking, an SEC injunction is a broad obey-the-law order prohibiting the defendant from future violations of securities laws.<sup>20</sup> Critics argue that such an injunction serves only as a slap on the wrist because it does little to deter first-time violations, does not provide restitution for the victims of violations, and imposes few, if any, costs on securities violators who may have profited enormously from their misconduct.<sup>21</sup> An injunction is, in the words of the Supreme Court, a "mild prophylactic."<sup>22</sup>

The power of an injunction is its effect on the defendant's future conduct. Those who continue their misconduct despite an injunction face substantial penalties, including civil or criminal contempt.<sup>23</sup> Those who obey the injunction may face other costs, including reputational

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17. The most recent amendment is in section 305 of the Sarbanes-Oxley Act of 2002. 15 U.S.C. §§ 77t(b), 78u(d) (2006).

18. The Insider Trading Sanctions Act of 1984 was the first piece of legislation to grant the SEC the authority to seek relief other than an injunction. *See* S. REP. NO. 101-337, at 6 (1990).

19. *See, e.g.*, SEC v. Advance Growth Capital Corp., 470 F.2d 40, 53 (7th Cir. 1972); SEC v. Wong, 252 F. Supp. 608 (D.P.R. 1966).

20. *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77t(b) (2008); Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (2008).

21. S. REP. NO. 101-337, at 6.

22. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

23. *See, e.g.*, SEC v. Universal Express, Inc., 546 F. Supp. 2d 132, 142 (S.D.N.Y. 2008) (ordering defendant to turn himself over for incarceration for failing to comply with equitable remedy of disgorgement).

damage or stigma.<sup>24</sup> Therefore, while an injunction may be sufficient to correct the behavior of a past violator, it does not have a significant preventive effect against first time violations.

Perhaps in recognition of the need for more effective remedies, courts began to develop separate "ancillary" remedies to supplement the general injunction.<sup>25</sup> An injunction was traditionally a remedy of courts of equity, and courts of equity have long fashioned other rules and remedies to suit the particular facts of a case.<sup>26</sup> Federal courts undertook to create such forms of "ancillary relief" in securities enforcement actions by reasoning that the SEC injunction actions provided them with equity jurisdiction over the case.<sup>27</sup> Courts willingly adapted these new remedies when it was "necessary and proper" to do so.<sup>28</sup> Among the forms of ancillary relief created by the courts were disgorgement of ill-gotten profits, as well as the officer and director bar.<sup>29</sup> Early cases barring defendants from serving as officers and directors specially emphasized the importance of such action when it was necessary to protect public investors, as this is the general purpose of the securities laws.<sup>30</sup>

Once the SEC has sufficiently established that a defendant has violated a provision of the securities laws, a court may grant an injunction or ancillary relief if the defendant's past conduct indicates that there is a reasonable likelihood of future violations.<sup>31</sup> The underlying violation, without more, is insufficient to demonstrate a likelihood of recurrence.<sup>32</sup> In assessing the likelihood of future violations, courts most commonly consider the following factors: (1) the defendant's history of past violations, (2) the degree of scienter involved in violations, (3) whether the violations are isolated or recurring and continuous, (4) the defendant's acceptance of responsibility and assurances against future miscon-

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24. See *Aaron v. SEC*, 446 U.S. 680, 703 (1980).

25. See, e.g., *SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994).

26. *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir. 1984).

27. *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 53 (7th Cir. 1972).

28. H.R. REP. NO. 101-616, at 28 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1394.

29. *Id.* at 1398.

30. See *Advance Growth Capital*, 470 F.2d at 53-54.

31. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 856-57 (2d Cir. 1968).

32. *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); see *SEC v. Jones*, 476 F. Supp. 2d 374, 384 (S.D.N.Y. 2007) (denying the SEC's request for an injunction where the SEC demonstrated only past misconduct).

duct, and (5) whether the defendant's occupation puts him or her in a position to commit further violations.<sup>33</sup>

The likelihood of recurrence standard for obtaining an injunction and its five-factor test continue to be important in officer and director bar cases in two ways. First, courts still enjoin persons from acting as officers or directors as a form of ancillary relief under their general equitable power to impose an injunction.<sup>34</sup> In those cases, proof of a violation and a showing that the defendant is likely to engage in future misconduct are the only requirements.<sup>35</sup> Second, under more recent cases involving the express officer and director bar statutes, courts have returned to the likelihood of recurrence standard when determining the propriety of permanently barring a corporate executive.<sup>36</sup>

### B. The Remedies Act

In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act ("Remedies Act") in response to the "wide range of securities law violations in the large and increasingly complex securities markets."<sup>37</sup> The Remedies Act amended the existing securities laws by granting the SEC the express authority to seek several new remedies, including officer and director bars.<sup>38</sup>

Congress's stated purpose in passing the Remedies Act was to grant the SEC the authority and flexibility to "maximize the remedial effects of its enforcement actions" and to "achieve the appropriate level of de-

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33. SEC v. Cavanaugh, 155 F.3d 129, 136 (2d Cir. 1998); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1477-78 (2d Cir. 1996); SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1048 (2d Cir. 1976).

34. See, e.g., SEC v. Posner, 16 F.3d 520 (2d Cir. 1994).

35. See generally *id.* at 521-22 ("The court found that they had committed securities law violations . . . and that their past securities law violations and lack of assurances against future violations demonstrated that such violations were likely to continue."); SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587, 611 (S.D.N.Y. 1993) ("The propriety of injunctive relief turns on whether 'there is a reasonable likelihood that the wrong will be repeated.'").

36. See *infra* Part I.D.

37. H.R. REP. NO. 101-616, at 14 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1381.

38. Remedies Act, Pub. L. No. 101-429, §§ 101, 201, 104 Stat. 931, 932, 935 (1990).

terrence in each case."<sup>39</sup> Implicit in this purpose was the view that the securities market was expanding beyond the SEC's enforcement capacity and that injunctions, the SEC's sole remedy up to that point, were inadequate to deter misconduct and too cumbersome to adapt to a specific defendant's violation.<sup>40</sup> Congress designed the Remedies Act to do more than expressly provide for remedies that were already implied. Rather, the Remedies Act was designed to strengthen the SEC's enforcement program and to deter violations.<sup>41</sup>

In terms of general deterrence, the officer and director bar is one of the most effective enforcement mechanisms at the SEC's disposal. To a corporate executive, a bar order may be more devastating than a monetary fine or even imprisonment.<sup>42</sup> Indeed, it is intended to be: the director and officer bar serves as a pecuniary sanction for wealthy fiduciaries who are likely to view a fine as an inconsequential cost of doing business.<sup>43</sup> Nevertheless, the officer and director bar is not a one-size-fits-all remedy. It is a severe sanction that may force a corporate executive to abandon her career and possibly her lifestyle.<sup>44</sup> In contrast, to a lower-ranking violator who has never served as a corporate manager and is unlikely to do so in the future, the officer and director bar may be an ineffective deterrent and would be less painful than a civil monetary penalty.<sup>45</sup> The legislative history makes clear, however, that Congress's

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39. H.R. REP. NO. 101-616, at 13 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1380.

40. See *id.* at 1381. The legislative history provides statistics showing the rapid growth of the securities markets in the decade leading up to the Remedies Act. The market boom and the concern that the SEC may not be able to police misconduct serve as premises for the conclusion that expresses remedies (and therefore more deterrence) is necessary. The report does not state that the SEC's sole remedy of injunction is insufficient to enforce and deter, but this is obviously an assumption.

41. *Id.*

42. Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1522 (1992) [hereinafter Barnard, *Substantially Unfit to Serve?*] (arguing that an officer and director bar is harsher than imprisonment because it deprives corporate executives of the potential ever to find a high-paying job).

43. *Id.* at 1495.

44. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 12. Note, however, that not all barred executives are in danger of losing everything. See, e.g., *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 596, 613 (S.D.N.Y. 1993) (barring defendants who were wealthy controlling shareholders of numerous corporations from exercising control or voting rights over the corporations).

45. *SEC v. Drucker*, 528 F. Supp. 2d 450, 451, 454 (S.D.N.Y. 2007) (barring defendant who committed insider trading as in-house counsel, but not barring tippee of



intent with the officer and director bar was to deter corporate misconduct and to send a signal to public investors that the markets were safe from the actions of proven violators.<sup>46</sup>

In an effort to limit the potentially devastating effects of the officer and director bar, Congress sought to apply it only to the most serious securities laws violators. Under the Remedies Act, a court was authorized to bar “any person who violated [either of the ‘hard core’ fraud provisions<sup>47</sup>] from acting as an officer or director of any [public company] if the person’s conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer.”<sup>48</sup>

Separated into its key components, the bar statute applied (1) to any person; (2) who was found by a court to have engaged in securities fraud; and (3) who was found to be substantially unfit to serve as an officer or director of a public company.<sup>49</sup> Thus, to obtain a bar, the SEC had a two-part burden: it was required to show fraud plus substantial unfitness by a preponderance of the evidence.<sup>50</sup>

Once a court has imposed an officer and director bar, it only prohibits the defendant from acting as an officer or director of a *public company*.<sup>51</sup> The term “public company” refers to a company that has over \$1,000,000 in assets and more than 500 shareholders.<sup>52</sup> Simply put, a public company is a corporation whose stock is held by a large number of widely dispersed shareholders. The securities laws protect the shareholders of such widely held corporations because they are less likely to have the knowledge, sophistication, or control sufficient to hire and fire management.<sup>53</sup> Nothing, however, prohibits a barred officer or

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inside information who was a retired police officer and was never likely to serve as a corporate manager).

46. H.R. REP. NO. 101-616, at 27 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1394.

47. LOSS & SELIGMAN, *supra* note 13, at 1510.

48. Remedies Act, Pub. L. No. 101-429, §§ 101, 201, 104 Stat. 931, 932, 935 (1990).

49. *Id.*

50. *See Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979) (holding preponderance of the evidence is the proper burden of proof in all SEC enforcement actions including debarment cases).

51. *See Remedies Act*, §§ 101, 201.

52. Securities Exchange Act of 1934, 15 U.S.C. § 78l (2000).

53. *See, e.g., SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953) (defining the public as those people for whom the securities laws were designed to protect); S. REP. NO. 101-337, at 21 (1990) (explaining the need for the officer and director bar because

director from serving as a manager of a non-public company, usually called a closely held company. Closely held companies are subject to minimal SEC regulation<sup>54</sup> and have become increasingly popular with the modern rise of "cash out" mergers<sup>55</sup> and other efforts to "go private".<sup>56</sup> Thus, the officer and director bar is a potentially severe sanction for corporate executives, but Congress has limited its application only to the most egregious violators and its reach only to public companies.

*C. Defining Substantial Unfitness and the Six-Factor Test*

By the time Congress passed the Remedies Act, the elements of securities fraud had been fairly well established.<sup>57</sup> The other requirement for obtaining an officer and director bar, "substantial unfitness," was a new term of art left undefined by the Remedies Act and the legislative history.<sup>58</sup> The definition of "substantial unfitness" thus became the central issue in the case law and academic literature dealing with the officer and director bar.<sup>59</sup>

The definition of "substantial unfitness" was not completely ambiguous, however. Sensible construction suggested that the test for "substantial unfitness" lay between two distinct boundaries. At one end, the defendant's act of fraud alone, without aggravating factors, could not be sufficient to justify a bar. After all, the required showing was fraud *plus*

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dispersed shareholders rarely have the collective power to oust violators from management).

54. Sections 12 and 13 of the Securities Exchange Act of 1934 do not require closely held companies to register their securities or make periodic reports. See 15 U.S.C. §§ 78(l), 78(m) (2008). Nevertheless, closely held companies and their principals are still subject to the anti-fraud provisions, which apply to *any* person. See 15 U.S.C. § 78j (2008); Securities Act of 1933, 15 U.S.C. § 77(q) (2000).

55. See DEL. CODE ANN. tit. 8, § 253 (2007) (defining "short form" or "cash out" merger).

56. David A. Stockton et al., *Going Private: The Best Option?*, NAT'L L. J., June 23, 2003, at 19 (citing a study by FactSet Mergerstat indicating that completed going-private deals, as a percentage of mergers and acquisition transactions, increased by approximately 23.7% from 2000 to 2002).

57. See LOSS & SELIGMAN, *supra* note 13, at 914-18 (outlining the elements of securities fraud and citing the court opinions that established those elements).

58. Stephen M. Cutler, Dir., SEC Div. of Enforcement, Speech by SEC Staff: Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002), available at <http://www.sec.gov/news/speech/spch538.htm>.

59. *Id.*

“substantial unfitness,” and the legislative history indicates that Congress favored limiting the application of the bar only to the most serious violators.<sup>60</sup> At the other end, the test for “substantial unfitness” needed to be more flexible than the test required for the SEC to obtain an injunction. If the SEC could easily establish that a defendant was likely to commit future violations as a corporate manager, then it could obtain a bar under its authority to seek an injunction.<sup>61</sup> In that case, the officer and director bar statutes would be rendered superfluous. Therefore, “substantial unfitness” could not logically be equated with the defendant’s likelihood of recurrence plus other factors. This view was supported by the fact that the Remedies Act was designed to enhance the SEC enforcement program, not to hinder it.<sup>62</sup> With these two guidelines in place, the “substantial unfitness” issue was left to judicial interpretation.

Courts quickly adopted a “substantial unfitness” test, initially suggested in a 1992 law review article by Professor Jayne Barnard.<sup>63</sup> Professor Barnard suggested that to determine whether a defendant is substantially unfit, courts should consider: (1) the egregiousness of the underlying violation, (2) the defendant’s repeat offender status, (3) the role of the defendant in the scheme to defraud, (4) the defendant’s degree of scienter, (5) the defendant’s economic stake in the violation, (6) the likelihood that misconduct will recur, and (7) the defendant’s appreciation of a corporate manager’s fiduciary obligations.<sup>64</sup> Courts that adopted this test abandoned the last factor and sometimes added it into the analysis of the defendant’s likelihood of recurrence.<sup>65</sup>

The six factors in Professor Barnard’s modified test are nearly identical to the six factors that courts have long applied in reviewing the propriety of sanctions imposed by the SEC in administrative proceedings.<sup>66</sup> In the seminal case *Steadman v. SEC*, the Fifth Circuit held

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60. See S. REP. NO. 101-337, at 20 (1990) (stating that a permanent bar may be especially appropriate where the defendant’s conduct was egregious or the defendant was a recidivist).

61. See *supra* Part I.A.

62. H.R. REP. NO. 101-616, at 14 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1381.

63. Cutler, *supra* note 58.

64. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1510-21.

65. See, e.g., *SEC v. Patel*, 61 F.3d 137, 141 (2d Cir. 1995).

66. See *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979). There are a few differences in Professor Barnard’s factors and the factors utilized by the court in *Steadman*: Barnard’s factors consider the defendant’s economic stake in the violation

that when the SEC seeks to impose an occupational bar, it must clearly articulate its reasons for believing that such a severe sanction is more appropriate than a less severe alternative.<sup>67</sup> To that end, *Steadman* held that the SEC may consider and discuss: (1) the egregiousness of the defendant's actions, (2) the isolated or recurrent nature of the infraction, (3) the degree of scienter involved, (4) the sincerity of the defendant's assurances against future violations, (5) the defendant's recognition of the wrongful nature of his conduct, and (6) the likelihood that the defendant's occupation will present opportunities for future violations.<sup>68</sup>

*Steadman* suggested that some factors – such as the egregiousness of the defendant's violation, the defendant's level of scienter and the likelihood of recurrence – may carry more weight than others.<sup>69</sup> Furthermore, *Steadman* held that the six factors were a list of possible considerations, and not a conjunctive test.<sup>70</sup> Thus, the SEC was not required to demonstrate facts to satisfy all six factors in order to justify its decision to impose a sanction.

Professor Barnard intended the six factor test to limit the application of the officer and director bar as a remedy for fraud.<sup>71</sup> She was concerned that the bar was too strict a punishment that, if applied unwisely, could detrimentally affect shareholder agency and the lives of talented, though tarnished, managers.<sup>72</sup>

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and the *Steadman* factors do not; the court in *Steadman* considered whether the defendant had recognized the wrongful nature of his conduct, while Professor Barnard asks whether the defendant understands his role as a corporate fiduciary. All other differences are minor changes in verbiage.

67. *Id.* at 1139-40.

68. *Id.* at 1140. The *Steadman* factors remain the test by which federal courts review the SEC's imposition of any sanction in an administrative court proceeding. *See, e.g., In re KPMG Peat Marwick LLP*, Exchange Act Release No. 43,862, 2001 SEC LEXIS 98, at \*98 (Jan. 19, 2001) (requiring a review of the *Steadman* factors before the SEC can impose sanctions in an SEC administrative proceeding); *In re Maria T. Giesge*, Admin. Proc. File No. 3-12747, Initial Decision Rel. No. 359, at 31-32 (Oct. 7, 2008).

69. *Steadman*, 603 F.2d at 1140.

70. *Id.*

71. *See* Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1510 (urging courts to exercise caution as the bar "inherently invites overuse").

72. *Id.* at 1522.

D. Patel and the Application of the Six Factor Test in Court.

In 1993, the Southern District of New York became the first court to apply Professor Barnard's six-factor test in *SEC v. Shah*.<sup>73</sup> The SEC sued Dilip Shah, alleging fraud in connection with Shah's scheme to defraud the FDA and his sale of company stock before the public learned of the government's investigation and the subsequent indictment.<sup>74</sup> At trial, Shah conceded that his trading constituted securities fraud.<sup>75</sup> The SEC sought an officer and director bar and the only unresolved issue was whether Shah was substantially unfit. The court, noting the need for a workable definition of "substantial unfitness," applied Professor Barnard's six-factor test.<sup>76</sup> The court's analysis led it to conclude that Shah was not substantially unfit, despite the fact that over a period of several years he had endangered the public health, defrauded the federal government and engaged in insider trading.<sup>77</sup> The court's six-factor analysis is summarized below:

- (1) *Egregiousness of the Underlying Violation*: The violation was not egregious because defendant avoided only a small loss by selling ahead of the public announcement of the indictment.
- (2) *Defendant's Repeat Offender Status*: There were no past violations of law.
- (3) *Defendant's Role in the Fraud*: Shah was an officer of the corporation and an active participant in the conspiracy to defraud the FDA.
- (4) *Defendant's Degree of Scierter*: The degree of scierter was low because there was no evidence of clandestine trading or tipping.
- (5) *Defendant's Economic Stake in the Violation*: The defendant received all of the loss that he avoided.

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73. *SEC v. Shah*, No. 92 Civ. 1952, 1993 WL 288285, at \*7 (S.D.N.Y. July 28, 1993). The basic facts of *Shah* are set out *supra* in the Introduction.

74. *Id.* at \*3.

75. *Id.* at \*7.

76. *Id.*

77. *Id.*

- (6) *Likelihood that Misconduct Will Recur*: The defendant is unlikely to commit future violations given his past record, the harshness of his criminal penalties, and the SEC’s monetary damages.<sup>78</sup>

In sum, Shah was the president of a public company who coordinated a scheme spanning several years to defraud the FDA and endanger the public welfare while trading in the company’s stock. Although the court did not find him substantially unfit, other courts have subsequently treated similar conduct as especially relevant in terms of showing egregiousness,<sup>79</sup> scienter,<sup>80</sup> and the likelihood of recurrence.<sup>81</sup>

Two years after *Shah*, the Second Circuit applied its own twist to the six-factor test in *Patel* and significantly raised the SEC’s burden for obtaining a bar in most cases.<sup>82</sup> The defendant in *Patel* was a co-conspirator in Shah’s scheme to defraud the FDA. Both Patel and Shah sold their shares of the company stock before the public learned of their illegal acts.<sup>83</sup> In contrast to *Shah*, the Southern District of New York did permanently bar Patel from acting as an officer or director of any public company on essentially the same set of facts as *Shah*.<sup>84</sup> On appeal, Patel argued that the six-factor test is “in essence a test of a defendant’s propensity for recidivism” and that the bar order issued against him should be reversed because the district court erroneously concluded that Patel was likely to commit future misconduct.<sup>85</sup> The Second Circuit agreed.<sup>86</sup> Elevating the sixth factor – the defendant’s likelihood of recurrence – above all other factors, the Second Circuit held that before issuing an officer and director bar, a district court must clearly state facts showing a defendant’s likelihood of recurrence, especially if the defendant has no

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78. *Id.*

79. *See* SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995) (holding that defendant’s scheme to defraud the FDA, in addition to his acts of securities fraud, was egregious).

80. SEC v. Global Telecom Servs., LLC, 325 F. Supp. 2d 94, 121-22 (D.Conn. 2004).

81. *Id.*

82. *Patel*, 61 F.3d at 141-43.

83. *Id.* at 138-39.

84. SEC v. Patel, No. 93 CIV. 4603, 1994 WL 364089, at \*4 (S.D.N.Y. July 13, 1994).

85. Brief for Defendant-Appellant Ratilal Patel at 16, SEC v. Patel, 61 F.3d 137, No. 94-6218 (2d Cir. Nov. 4, 1994).

86. *Patel*, 61 F.3d at 141-42.

past violations.<sup>87</sup> *Patel* also held that courts should always consider whether a temporary or conditional bar is a more appropriate remedy, especially where the defendant has no prior history of violations.<sup>88</sup>

*Patel* sought to limit the harsh effects of the officer and director bar as a remedy against corporate executives,<sup>89</sup> but it created more problems than it resolved. First, the officer and director bar was intended to be harsh. Its purpose was to serve as a conspicuous deterrent and a powerful means of penalizing the most egregious corporate violators of the public trust.<sup>90</sup> Second, the Remedies Act made the officer and director bar an express remedy as a part of its initiative in making the SEC's enforcement program more effective and efficient.<sup>91</sup> By equating "substantial unfitness" with a defendant's likelihood of recurrence, *Patel* effectively elevated the officer and director bar, as an express remedy, to the same, if not a higher, standard than was required for a bar as a form of ancillary injunctive relief. This was a dramatic reversal of Congress's desire to strengthen SEC enforcement mechanisms. Third, *Patel* held that the six factors were helpful considerations but not the elements of a mandatory or conjunctive test, which is precisely what the *Steadman* court had held.<sup>92</sup> Nonetheless, *Patel* immediately abandoned this idea by holding that a bar may not be ordered without a positive showing of the defendant's likelihood of recurrence.<sup>93</sup> Fourth, *Patel*'s holding made it very unlikely that a first-time offender would be barred even if his or her misconduct was highly egregious, weakening the bar's effectiveness as a deterrent.<sup>94</sup> Fifth, even if the Second Circuit was justified in insist-

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87. *Id.* at 141-42; Cf. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1517 (stating that the defendant's likelihood of recurrence is at the core of the test for *substantial unfitness*).

88. *See Patel*, 61 F.3d at 142.

89. *See id.* at 141-42 (noting the stigma and loss of livelihood that results from an officer and director bar).

90. *See* H.R. REP. NO. 101-616, at 13 (1990), *as reprinted in* 1990 U.S.C.C.A.N. 1379, 1380-81.

91. *See id.*

92. *See Patel*, 61 F.3d at 141; SEC v. *Steadman*, 603 F.2d 1126, 1140 (5th Cir. 1979).

93. *See Patel*, 61 F.3d at 142.

94. The defendant's conduct in *Patel* is a good example: the court reversed the district court's bar order because the defendant had no past history of securities violations and because the district court pointed only to facts of the underlying violation to show a likelihood of future misconduct. *Id.* at 141-42. Of course, it is entirely possible that an egregious and willful violator will have no history of violations and that

ing on a showing of Patel's likelihood of recidivism, it could easily have found such facts in the record. The factors sufficient to prove a defendant's likelihood of future violations (the old test for obtaining an injunction in an SEC enforcement action) are almost identical to the first five factors in the *Steadman-Barnard* six-factor test.<sup>95</sup> Thus, the Second Circuit had before it sufficient facts to establish Patel's likelihood of recurrence; nothing precluded the district court or the Second Circuit from making such a finding.

Despite its problems, *Patel* became binding precedent in the Second Circuit and was extremely influential in other circuits.<sup>96</sup> As a result, courts began denying the SEC's request for a permanent officer and director bar even in cases where the defendant had committed egregious and criminal acts of securities fraud.<sup>97</sup> Furthermore, temporary and conditional bars became much more common forms of sanctions where the defendant was found "substantially unfit."<sup>98</sup> The "substantial unfitness" standard thus became a significant obstacle to the SEC enforcement regime, which Congress had sought to augment in the Remedies Act.

#### E. The Sarbanes-Oxley Act

In 2002, Congress passed the Sarbanes-Oxley Act to "address the systematic and structural weaknesses affecting [the] capital markets which were [recently] revealed by repeated failures of" auditors, corporate managers, and broker-dealers.<sup>99</sup> Among the provisions designed to

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the only facts available to show "substantial unfitness" are those of the underlying violation. In those cases, the fact finder will be unable to demonstrate anything more than the prediction that an egregious violator of the public trust is likely to violate it again if given the chance.

95. Compare note 33 and accompanying text with notes 67 & 68 and accompanying text.

96. See, e.g., SEC v. First Pac. Bancorp, 142 F.3d 1186, 1193 (9th Cir. 1998).

97. See, e.g., SEC v. McCaskey, No. 98 Civ. 6153, 2001 U.S. Dist. LEXIS 13571, at \*18-21 (S.D.N.Y. Sept. 4, 2001) (declining SEC's request for a permanent bar of a firm manager that had made numerous false representations to investors over a number of years); SEC v. Farrell, No. 95-CV-6133T, 1996 WL 788367, at \*8 (W.D.N.Y. Nov. 6, 1996) (holding that a bar is not appropriate for a talented director who had tipped and traded company stock prior to the announcement of a merger and was subsequently convicted for insider trading).

98. See, e.g., SEC v. Save the World Air, Inc., No. 01 Civ. 11586, 2005 U.S. Dist. LEXIS 28313, at \*50-52 (S.D.N.Y. Nov. 15, 2005); *McCaskey*, 2001 U.S. Dist. LEXIS 13571, at \*20 (imposing six-year bar from serving as an officer or director).

99. S. REP. NO. 107-205, at 2 (2002). See LOSS & SELIGMAN, *supra* note 13, at



enhance the responsibility of corporate managers, Congress amended the director and officer bar statutes by changing the standard for obtaining a bar from “substantial unfitness” to mere “unfitness.”<sup>100</sup> Before the passing of Sarbanes-Oxley, SEC staff publicly expressed frustration with the application of the popular six-factor test in *Patel* and its progeny.<sup>101</sup> Through its communications with the SEC during the drafting process, Congress was aware that courts had become increasingly hesitant to bar corporate managers, even those who had engaged in egregious and criminal acts of securities fraud.<sup>102</sup> Indeed, Congress’s purpose in amending the statutory language from “substantial unfitness” to “unfitness” was to ease the courts’ reluctance to impose officer and director bars in such cases.<sup>103</sup>

Just as “substantial unfitness” was undefined in the Remedies Act, “unfitness” was also undefined in Sarbanes-Oxley. Nevertheless, the general tenor of Sarbanes-Oxley and its legislative history show that Congress intended to make the standard less onerous on the SEC and to signal to the courts that a change was necessary in the application of the director and officer bar.<sup>104</sup> Thus, the lower standard of “unfitness,” although undefined, was Congress’s solution to *Patel* and its influence as the prevailing judicial interpretation of the officer and director bar statutes.

One interpretation of the “unfitness” standard appears in a speech by David Cutler, former Director of the SEC’s Division of Enforcement, in which he suggested that a bar should be appropriate whenever a corporate executive has committed a “single serious breach of the public trust.”<sup>105</sup> This interpretation is consistent with Congress’s view of the officer and director bar as provided in the legislative history of the Remedies Act, which states that a bar is particularly appropriate where the defendant engaged in fraud as a corporate fiduciary<sup>106</sup> and the mis-

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194-208 (reciting a brief history of the corporate scandals that prompted Congress to pass Sarbanes-Oxley and a concise list of the provisions of the Act).

100. Sarbanes-Oxley Act of 2002 § 305, 15 U.S.C. §78u (2006); S. REP. NO. 107-205, at 26-27.

101. See Cutler, *supra* note 58.

102. S. REP. NO. 107-205, at 26-27.

103. *Id.* at 27.

104. *Id.* at 26-27.

105. Cutler, *supra* note 58.

106. H.R. REP. NO. 101-616, at 31 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1394.

conduct was egregious.<sup>107</sup> Moreover, such a scenario likely satisfies three of the six factors: it is egregious; the defendant is engaging in fraud while holding the position of a corporate fiduciary; and as with all fraud, scienter is present.<sup>108</sup> Such misconduct would justify a bar under a disjunctive test like *Steadman's*, but likely not under *Patel's*, unless the defendant had engaged in past misconduct or other facts clearly demonstrated a likelihood of future misconduct.<sup>109</sup>

Sarbanes-Oxley marked a dramatic change in the way the government sought to use the officer and director bar.<sup>110</sup> First, Congress clearly intended to overrule *Patel* and the line of cases that required the SEC to demonstrate a likelihood of recurrence in each case.<sup>111</sup> Indeed, some district courts in the Second Circuit support this view.<sup>112</sup> These cases, which hold that the defendant's likelihood of future misconduct is not a requirement to institute a bar, support the inference that Congress overruled *Patel* because courts in the Second Circuit would be bound by *stare decisis* and therefore obligated to follow *Patel* unless it was specifically overruled. Second, Sarbanes-Oxley gave the SEC the authority to call any person before an administrative judge and request an officer and director bar.<sup>113</sup> Some commentators have criticized this power because it gives the SEC the advantage of imposing a bar before its own tribunal and according to its own interpretation of "unfitness."<sup>114</sup> These concerns may be somewhat misguided as the SEC faces substantial evidentiary burdens in administrative actions<sup>115</sup> and the test for obtaining any sanction in an SEC administrative proceeding is the *Steadman* six-factor test.<sup>116</sup> Moreover, the SEC has sought very few officer and director bars in administrative proceedings.<sup>117</sup>

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107. S. REP. No. 101-337, at 17 (1990).

108. *Grandon v. Merrill Lynch & Co., Inc.*, 147 F.3d 184, 194 (2d Cir. 1998).

109. *See supra* Part I.D.

110. *See* Kris Frieswick, *Bar Hopping*, CFO MAG., Mar. 1, 2004, available at <http://www.cfo.com/article.cfm/3011961?f=related> (quoting John X. Peloso).

111. *See id.*

112. *See* SEC v. Drucker, 528 F.Supp.2d 450 (S.D.N.Y. 2007); SEC v. Global Telecom Servs., LLC, 325 F. Supp. 2d 94 (D. Conn. 2004).

113. Sarbanes-Oxley Act of 2002 § 1105, 15 U.S.C. §§ 77h-1(f), 78u-3(f) (2006).

114. *See* Jayne W. Barnard, *SEC Debarment of Officer and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391, 392 (2004).

115. Brian A. Ochs et al., *Sanctions and Collateral Consequences*, in THE SECURITIES ENFORCEMENT MANUAL 211 (Kirkpatrick & Lockhart Preston Gates Ellis LLP ed., 2d ed. 2007).

116. *In re* KPMG Peat Marwick LLP, Exchange Act Release No. 43,862, 2001 SEC

Despite the changes that Sarbanes-Oxley brought to the jurisprudence of the officer and director bar, its purpose is fundamentally consistent with the purposes of the Remedies Act and the purposes of the securities laws dating back to the original Securities Act of 1933. The securities laws aimed to facilitate disclosure and promote fairness in the market.<sup>118</sup> The SEC was meant to be the advocate for the public investor.<sup>119</sup> The SEC's enforcement remedies were supposed to effectuate restitution of illegal investor losses, punish wrongdoers, and deter potential violators.<sup>120</sup> Congress's amendment to the officer and director bar statutes in Sarbanes-Oxley was not an errant act; rather, it was Congress's attempt to realign those courts that strayed from the original purposes set out by the securities laws.

## II.

Most courts have yet to recognize this change. Many courts still cite "substantial unfitness" as the standard for imposing an officer and director bar.<sup>121</sup> Other courts have noted the amended language but maintain the status quo by emphasizing the importance of the defendant's history of violations and the likelihood of recurrence over other considerations.<sup>122</sup> Many courts also continue to follow *Patel* by asking whether a temporary bar is appropriate in every case.<sup>123</sup> Each of these approaches is problematic because Congress amended the bar statutes to end the courts' reliance on *Patel*, and to allay the courts'

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LEXIS 98, at \*98 (Jan. 19, 2001).

117. Ochs et al., *supra* note 115, at 211-12.

118. See SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

119. See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 157 (3d ed. 2003).

120. See H.R. REP. NO. 101-616, at 13 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1381-82.

121. See, e.g., SEC v. Aqua Vie Beverage Corp., No. CV 04-414-S-EJL, 2008 WL 1914723, at \*2 (D. Idaho Apr. 29, 2008); SEC v. Platforms Wireless Int'l, Corp., No. 04CV2105, 2007 WL 1238707, at \*14-15 (S.D. Cal. Apr. 25, 2007) (*overruled on other grounds*); SEC v. Universal Express, Inc., 475 F. Supp. 2d 412, 429 (S.D.N.Y. 2007); SEC v. Pardue, 367 F. Supp. 2d 773, 776-77 (E.D. Penn. 2005); SEC v. Johnson, No. 02-5490, 2004 WL 5561799, at \*4 (D.N.J. Aug. 27, 2004).

122. See, e.g., SEC v. Koenig, 532 F. Supp. 2d 987, 993-94 (N.D. Ill. 2007) (granting officer and director bar after considering factors and specifically determining that there was a likelihood that defendant would engage in future misconduct).

123. See, e.g., SEC v. Save the World Air, Inc., No. 01 Civ. 11586, 2005 U.S. Dist. LEXIS 28313, at \*50-52 (S.D.N.Y. Nov. 15, 2005).

reluctance to permanently bar individuals who cannot be trusted as corporate fiduciaries.<sup>124</sup> Because the bulk of the case law following Sarbanes-Oxley demonstrates that the courts misunderstand the director and officer bar amendment, Congress’s intent has yet to be fulfilled.

A. Courts Still Cite “Substantial Unfitness” as Standard

Most of the case law after Sarbanes-Oxley demonstrates that courts remain unaware of the amended officer and director unfitness standard. In these cases, the courts continue to state that the imposition of an officer and director bar requires a showing of “substantial unfitness.”<sup>125</sup> These courts have stated the law incorrectly. Furthermore, these opinions show that courts have misunderstood those aspects of the “substantial unfitness” test that Sarbanes-Oxley sought to rectify.<sup>126</sup> Many of these courts continue to cite *Patel*, not only as the genesis of the six-factor test, but also for the position that a temporary bar should always be considered before imposing a permanent bar.<sup>127</sup> Moreover, these courts’ analyses continue to place too much emphasis on the defendant’s likelihood of recurrence.<sup>128</sup> Thus, it is insufficient to say that these opinions have simply neglected to state the correct “unfitness” standard; the greater problem lies in their failure to observe the fundamental change in the law brought about by Sarbanes-Oxley.

B. Courts Note Change in Statutory Language  
But Have Not Changed Analysis

Some courts have acknowledged the linguistic change from “substantial unfitness” to “unfitness,” but have not yet adjusted the substance of the test accordingly.<sup>129</sup> In essence, for these courts, the words

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124. S. REP. No. 107-205, at 26-27 (2002).

125. See, e.g., *Aqua Vie Beverage Corp.*, 2008 WL 1914723, at \*2; *Platforms Wireless Int’l, Corp.*, 2007 WL 1238707, at \*14-15; *Universal Express*, 475 F. Supp. 2d at 429; *Pardue*, 367 F. Supp. 2d at 776-77; *Johnson*, 2004 WL 5561799, at \*4.

126. See *supra* notes 96-100 and accompanying text.

127. See *Aqua Vie Beverage Corp.*, 2008 WL 1914723, at \*2 (stating standard is substantial unfitness and granting a temporary bar); *Platforms Wireless Int’l, Corp.*, 2007 WL 1238707, at \*14-15.

128. See, e.g., *SEC v. Koenig*, 532 F. Supp. 2d 987, 993-94 (N.D. Ill. 2007).

129. See *SEC v. Save the World Air, Inc.*, No. 01 Civ. 11586, 2005 U.S. Dist. LEXIS 28313, at \*48-52 (S.D.N.Y. Nov. 15, 2005) (citing standard as “unfitness” but temporarily barring defendant who had no past history of violations in the United

have changed, but the meaning remains the same.<sup>130</sup> This is problematic for two reasons. First, it suggests that *Patel* retains considerable influence despite Congress's determination to overrule *Patel* in Sarbanes-Oxley. Second, to the extent that courts have noted a change in the language, it is unclear why so few have openly stated the issue and attempted to find an acceptable interpretation of the new "unfitness" standard.<sup>131</sup>

### C. Courts Offer No Analysis

A few courts since Sarbanes-Oxley have adjusted their analysis in response to the amended standard by completely dispensing with any determination of the defendant's "unfitness."<sup>132</sup> This approach, in which courts try to satisfy the lesser "unfitness" standard with lax legal analysis, is unacceptable. The purpose of the "unfitness" inquiry is for the court to find some nexus between the defendant's act of fraud and the need for a bar.<sup>133</sup> The defendant and the public must receive some explanation for the court's decision, and the appellate courts need to see a basis for the trial court's conclusion, to determine whether the lower court abused its discretion.

While the test was applied too stringently in *Patel*, these courts have allowed it to become too lenient. If Congress had intended courts to impose a bar for every commission of fraud, it would have dispensed with the "unfitness" requirement all together. Courts should continue to engage in the unfitness inquiry by providing a full and clear analysis of the law and facts of each case.

Each of the above categories of court action is an example of a common problem: courts have responded to the amended language in Sarbanes-Oxley with unacceptable applications of the new "unfitness" standard. Ignorance of the amendment and erroneous adherence to

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States); SEC v. Maxxon, No. 02-CV-975-H(J), 2005 WL 6090229, at \*5 (N.D. Okla. Mar. 11, 2005) (acknowledging "unfitness" as standard and noting defendant's ongoing and egregious pattern of fraudulent misconduct, but temporarily barring defendant without finding a likelihood of recurrence).

130. The most likely explanation for these decisions is that these courts continue to look to judicial precedent for guidance and do not realize that the amendment of the bar statute was intended to correct problems within that body of precedent.

131. One of the few courts to openly address the amended language of the bar statute was the D.C. District in SEC v. Levine, 517 F. Supp. 2d 121 (D.D.C. 2007). For a discussion of the *Levine* case, see *infra* Part III.B.

132. See, e.g., SEC v. Henke, 275 F. Supp. 2d 1075 (N.D. Cal. 2003).

133. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1494.

*Patel's* still-powerful influence in the courts may be the explanation. Another possibility is that courts are concerned about the harsh consequences of an officer and director bar and are quietly adjusting their legal analysis in an effort to limit those consequences. Still, some courts appear only too willing to bar a defendant without setting forth a clear and rational basis for their decision. The officer and director bar was intended to be a powerful deterrent and remedy for fraudulent misconduct but, as with all SEC sanctions, the interest of the public in fair and efficient markets must be balanced with the interests of the defendant.<sup>134</sup> Before the officer and director bar can operate as intended, courts must respond to the amended standard by developing a fair and workable test for determining whether a defendant is unfit.

### III.

Courts could depart in several ways from the pre-Sarbanes-Oxley case law to adjust the test from one that determines "substantial unfitness" to one that determines "unfitness." At least one federal district court has already attempted to develop a test to determine a defendant's "unfitness."<sup>135</sup> That court's test is offered here as a potential solution. As with most human endeavors, however, the simplest solution is likely the most effective. If Congress meant Sarbanes-Oxley to overrule certain aspects of the *Patel* holding, then courts should proceed with the six factors without those offending parts.

In creating a test to determine whether a defendant is unfit to serve as an executive of a public company, courts and commentators should be willing to rethink the purposes of the officer and director bar. Congress provided two chief purposes in the Remedies Act's legislative history: deterrence and protection of public investors from proven violators.<sup>136</sup> Congress also charged courts with the duty to balance the government's interest in obtaining a bar<sup>137</sup> with the defendant's interest in retaining his or her means of making a living.<sup>138</sup> Any proposed solution to this lingering "unfitness" problem should serve the purposes of the bar and

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134. SEC v. Steadman, 603 F.2d 1126, 1139 (5th Cir. 1979).

135. *Levine*, 517 F. Supp. at 144-46.

136. H.R. REP. NO. 101-616, at 27 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1394.

137. The SEC is ultimately interested in protection of shareholders and the honesty, integrity, and efficiency of the market. *Id.* at 1381.

138. *Steadman*, 603 F.2d at 1139-40.

promote fairness by maintaining the proper balance between the interests of the government and the defendant.

A. Proposed Test for Determining Whether Defendant is Unfit to Serve

This Note suggests that courts acknowledge the Sarbanes-Oxley amendment and seek to determine a defendant's "unfitness" through consideration and analysis of the *Steadman*-Barnard six factors. No single factor should be dispositive; courts should even be prepared to impose a bar in the absence of any of the listed factors, as long as they provide a reasoned analysis of their conclusion that the defendant is unfit to serve as a director or officer. The advantage of this solution is that it creates flexibility by allowing courts to examine and present the facts of each case against a variety of considerations without making any factor or combination of factors dispositive of "unfitness" or "fitness." Furthermore, this method is the least disruptive to the existing body of precedents and is consistent with the purposes of the Remedies Act and Sarbanes-Oxley.<sup>139</sup>

This proposed "unfitness" test satisfies Congress's intent by resolving the major problem with *Patel*, specifically, the requirement that the SEC show one of the six "considerations" in every case before the court may issue a bar order.<sup>140</sup> Because securities fraud occurs in a variety of forms, the "unfitness" inquiry must be sufficiently flexible to protect the market from unscrupulous corporate fiduciaries.<sup>141</sup> The proposed solution provides an appropriate level of flexibility. Whereas *Patel* required a clear showing of one factor, the new test would permit the presence of some factors to make up for the absence of others. Thus, a court could impose an officer and director bar without being rigidly forced to show any particular factor or combination of factors.

The proposed test is the least disruptive interpretation of the Sarbanes-Oxley amendment because it adheres to the basic six-factor test found in *Patel* and the rest of the officer and director bar cases, while dispensing with the problematic legal holdings of those cases. Furthermore, it is consistent with *Steadman* and the long line of SEC enforcement case law.<sup>142</sup>

The new test is flexible enough to be applied to a wide array of cor-

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139. See *supra* Parts I.C and I.E.

140. See *supra* Part I.E.

141. See *id.*

142. See *supra* note 67 and accompanying text.

porate misconduct. Congress clearly favored such flexibility when it established the officer and director bar in the Remedies Act.<sup>143</sup> In addition, courts have long been wary of rigid definitions in federal securities laws.<sup>144</sup> A rigid or static definition or test invites clever minds to circumvent the protections provided by the law.<sup>145</sup> In the same way, "unfitness" should not be a static concept, which may be the reason Congress left it undefined.<sup>146</sup> Any workable test for "unfitness" must be flexible enough to address the many forms of misconduct that may occur in the market, and must also be able to adapt as the market grows and changes. Such flexibility has long been the hallmark in securities law<sup>147</sup> and is consistent with Sarbanes-Oxley, which was a reaction to previously unimaginable corporate scandals.<sup>148</sup> It is also consistent with the purposes of both the Remedies Act and Sarbanes-Oxley, which sought to provide the SEC with an effective remedy and deterrent.<sup>149</sup>

The proposed test is fair and provides courts with an appropriate level of discretion to impose or deny an officer and director bar. A permanent officer and director bar is an extraordinary sanction to impose on a corporate executive and may interfere with shareholders' right to select firm managers.<sup>150</sup> At the same time, the officer and director bar is an effective way to keep untrustworthy executives out of the management teams of public companies and to send a strong signal to the market that misconduct will not be tolerated.<sup>151</sup> In considering these competing interests, Congress has stated the following:

Some commentators have suggested that a court ordered bar infringes upon the right of shareholders to determine for themselves who should serve as their elected management. However, public

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143. S. REP. NO. 101-337, at 2, 7 (1990).

144. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (asserting a definition for "investment contract" with sufficient flexibility to "meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits").

145. *Id.*

146. *See supra* note 58 and accompanying text.

147. *Howey*, 328 U.S. at 299.

148. LOSS & SELIGMAN, *supra* note 13, at 194-208.

149. *See supra* Parts I.B and I.E.

150. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1490-91.

151. Congress intended the officer and director bar to serve two principal purposes: assurance to public investors that the securities markets are safe and deterrence of corporate misconduct. H.R. REP. NO. 101-616, at 27 (1990), *as reprinted in* 1990 U.S.C.C.A.N. 1379, 1394.



shareholders may lack sufficient control to remove securities law violators from office or otherwise to protect their own interests. In addition, in some cases, the shareholders may have been the direct beneficiaries of the wrongdoing and thus may have little economic incentive to vote out the violators. Moreover, broader public interests are involved when the actions of the violator undermine the integrity of the markets.<sup>152</sup>

The proposed test allows courts the flexibility to consider any combination of the six factors and reach a conclusion that balances these competing interests and provides a fair and effective result in each case. Courts should make full use of the factual record and explain their findings in each case. Once courts begin to apply the suggested test, the developing body of case law will guide later courts and litigants in determining the likelihood or appropriateness of imposing a bar in any given situation.

Finally, the proposed test resolves the problems with prior case law, particularly *Patel*, as well as any ambiguity in Professor Barnard's six-factor test. *Patel*'s fundamental problem was that it required the government to demonstrate that the defendant was likely to engage in future misconduct before a bar could be imposed.<sup>153</sup> Professor Barnard likewise stated that this one factor – the defendant's likelihood of recurrence – was at the core of the "unfitness" inquiry<sup>154</sup> and admonished Congress to amend the bar statutes with language requiring the SEC to show the defendant's likelihood of recurrence in every case.<sup>155</sup> Nevertheless, Congress has taken the position that an officer and director bar is especially appropriate where corporate executives have engaged in egregious fraud without regard for the defendant's likelihood of recurrence.<sup>156</sup> Furthermore, the legislative history of Sarbanes-Oxley indicates that the statute was amended in response to cases like *Patel*.<sup>157</sup> Under the proposed "unfitness" test, the government would be able to obtain a bar against defendants like *Patel* without demonstrating the defendant's likelihood of future misconduct, so long as it could show other factors, such

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152. S. REP. NO. 101-337, at 18 (1990).

153. See *supra* notes 86-94 and accompanying text.

154. Barnard, *Substantially Unfit to Serve?*, *supra* note 42, at 1517.

155. Jayne W. Barnard, *The SEC's Suspension and Bar Powers in Perspective*, 76 TUL. L. REV. 1253, 1271-72 (2002).

156. S. REP. NO. 101-337, at 17.

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

as egregiousness, scienter, and the fact that the defendant is a corporate fiduciary.

B. Professor Barnard’s Nine-Factor Test for Determining “Unfitness”

An alternative solution to that suggested by this Note is a proposal by Professor Barnard in a 2005 law review article.<sup>158</sup> Barnard suggested that courts determine “unfitness” by considering the following nine factors:

(1) the nature and complexity of the scheme, (2) the defendant’s role in the scheme, (3) the use of corporate resources in executing the scheme, (4) the defendant’s financial gain (or loss avoidance) from the scheme, (5) the loss to investors and others as a result of that scheme, (6) whether the scheme represents an isolated occurrence or a pattern or misconduct, (7) the defendant’s use of stealth and concealment, (8) the defendant’s history of business and related misconduct, and (9) the defendant’s acknowledgement of wrongdoing and the credibility of his contrition.<sup>159</sup>

Here, Professor Barnard suggests that courts not consider the list exhaustive nor any of the factors dispositive.<sup>160</sup> Additionally, while she urges courts to raise the SEC’s burden of proof from preponderance of the evidence to clear and convincing evidence,<sup>161</sup> she also seems to suggest that a court may find a defendant unfit without all factors being present.<sup>162</sup>

At least one court has applied Professor Barnard’s new formulation.<sup>163</sup> The court in *SEC v. Levine*, unlike most other courts following Sarbanes-Oxley, expressly acknowledged that Congress had amended

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158. Jayne W. Barnard, *Rule 10-b and the “Unfitness” Question*, 47 ARIZ. L. REV. 9 (2005) [hereinafter Barnard, *The “Unfitness” Question*].

159. *Id.* at 46.

160. *Id.*

161. *Id.* at 45. It is highly unlikely that any court would raise the burden of proof from preponderance of the evidence to clear and convincing evidence. *See SEC v. Steadman*, 603 F.2d 1126, 1139 (5th Cir. 1979) (holding that preponderance of the evidence is the proper standard in all SEC enforcement and disbarment actions as any higher standard would be detrimental to the public interest).

162. *See* Barnard, *The “Unfitness” Question*, *supra* note 158, at 47 (suggesting that courts find unfitness in cases of high egregiousness, “especially when *some* of the other factors listed below are present” (emphasis added)).

163. *SEC v. Levine*, 517 F. Supp. 2d 121 (D.D.C. 2007).

the officer and director bar statutes and appropriately sought a method for determining the new, reduced “unfitness” standard.<sup>164</sup> Ultimately, the *Levine* court barred the defendant for ten years, a sanction reminiscent of *Patel*’s insistence that courts favor temporary officer and director bars over permanent bars.<sup>165</sup> Furthermore, the court pointed to the defendant’s active management of a public company at all times during the trial as evidence that the defendant was likely to be involved in future misconduct.<sup>166</sup> This suggests that the *Levine* court was not acting independent of the influence of *Patel*. That is not surprising, however, because Professor Barnard’s nine-factor test strongly encourages courts to find that the defendant is likely to engage in future misconduct before imposing a bar.<sup>167</sup>

Professor Barnard’s nine-factor test has both positive and negative attributes. On the one hand, it is undeniably flexible because it provides courts with nine possible considerations rather than six. These considerations may prove useful for courts that have reached a stalemate in applying the six-factor test and need more factors to reach a conclusion. On the other hand, Professor Barnard indicates that, in addition to considering the nine factors, courts should find that the defendant is likely to engage in future misconduct before imposing a bar.<sup>168</sup> In this way, the new test ignores the most critical meaning of the “unfitness” standard: neither the defendant’s likelihood of recurrence nor any other particular factor should be required.<sup>169</sup> The addition of new factors without the resolution of this issue signals a return to the *Patel* framework, and is therefore not a solution that seeks to honor Congressional intent in Sarbanes-Oxley. This Note suggests that courts should not so thwart the will of Congress. Congress overruled *Patel*’s static formulation of the “substantial unfitness” test in Sarbanes-Oxley and demonstrated its desire that courts develop and use a more flexible standard.<sup>170</sup>

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164. *Id.* at 144.

165. *Id.* at 146.

166. *Id.* at 131-32.

167. Barnard, *The “Unfitness” Question*, *supra* note 158, at 15.

168. *Id.*

169. *See supra* Part I.E.

170. *See id.*

C. Comparison of the Proposed Test and Professor Barnard’s  
Nine-Factor Test

To illustrate the differences between the “unfitness” test proposed by this Note and Professor Barnard’s nine-factor test, I will apply both tests to the facts of the *Patel* case, and compare the results. This comparison will highlight the strengths of the proposed test and the weaknesses of the alternative nine-factor test.

*The Proposed Test*

Applying the proposed test to the facts of *Patel*,<sup>171</sup> the six factors break down as follows:

- (1) *Egregiousness of the Underlying Violation*: The violation was egregious because it resulted in enormous shareholder losses, it involved a scheme to defraud the FDA, and it showed a blatant disregard for public safety. This favors a bar.
- (2) *Defendant’s Repeat Offender Status*: The defendant has no past violations of law. This favors denial of a bar.
- (3) *Defendant’s Role in the Fraud*: The defendant was an officer of the corporation and an active participant. This favors a bar.
- (4) *Defendant’s Degree of Scienter*: The defendant’s fraudulent acts were not negligent, but rather were intentional or highly reckless; the defendant knew or reasonably should have known that the scheme to defraud the FDA was illegal and that, if caught, the company’s stock price would plummet. Furthermore, the defendant knew or reasonably should have known that he defrauded investors who purchased his shares in the selloff prior to the public announcement of the indictment. This favors a bar.
- (5) *Defendant’s Economic Stake in the Violation*: The defendant’s scheme initially increased the company’s value by making it appear highly competitive; the defendant then sold a block of his shares to avoid the inevitable losses. This favors a bar, though the defendant may argue that the loss

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171. See *supra* Part I.D for a discussion of the *Patel* case.

avoided was not large in comparison with total shareholder losses and the total amount of stock he held.

- (6) *Likelihood that Misconduct Will Recur*: The defendant's scheme was ongoing and showed his blatant disregard for laws protecting prescription drug users and public investors. This factor does not clearly favor a bar. That is, simply restating the facts of the underlying violation may not be sufficient to demonstrate a likelihood of recurrence, especially if the defendant has accepted responsibility for his actions. Nevertheless, applying the five factor test currently used by courts to determine the likelihood of recurrence when issuing an injunction, a court may find a likelihood of future misconduct. The scheme was ongoing and continuous, the violation evidenced a high level of scienter, and the nature of the defendant's profession places him at risk for future violations.<sup>172</sup>

Under the proposed test, a court could find the defendant unfit to serve as the manager of a public company. Even if the defendant has no history of past violations, or if the court is not convinced that the SEC has established a likelihood of future misconduct, the court may still impose a bar if, in its discretion, it is convinced that the egregiousness of the violation, the high level of scienter, and the defendant's role as a corporate fiduciary at the time of the fraud render the defendant unfit.

#### *Professor Barnard's Nine-Factor Test*

Applying Professor Barnard's more recent nine-factor test<sup>173</sup> to the facts in *Patel*,<sup>174</sup> a court may find as follows:

- (1) *The Nature and Complexity of the Scheme*: The scheme was complex, as it involved a conspiracy with FDA staff and was unlikely to be discovered without the intervention of a federal investigation. The scheme endangered the public and introduced false information about the company into the

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172. See, e.g., *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 611 (S.D.N.Y. 1993).

173. See Barnard, *The "Unfitness" Question*, *supra* note 158, at 46-53 (listing and discussing the factors).

174. See *supra* Part I.D.

securities market, resulting in shareholder losses. This favors a bar.

- (2) *The Defendant's Role in the Scheme*: The defendant served as a corporate fiduciary while engaging in the fraud and may have had a leadership role in the scheme. This favors a bar.
- (3) *The Use of Corporate Resources in Executing the Scheme*: The defendant may have used corporate resources or time to engage in the fraud, but there are no facts that firmly establish this. This favors denial of a bar.
- (4) *The Defendant's Financial Gain (or Loss Avoidance) from the Scheme*: The defendant profited from the scheme, though the amount of profit and loss avoidance may not be sufficient to find the defendant unfit. This factor may or may not favor a bar.
- (5) *The Loss to Investors and Others as a Result of the Scheme*: The defendant's scheme caused a major decline in the price of the company's publicly traded stock and shareholders likely suffered heavy losses. This favors a bar.
- (6) *Whether the Scheme Represents an Isolated Occurrence or a Pattern of Misconduct*: The conspiracy with the FDA staff was ongoing, but the illegal sell-off of company stock occurred only once. This may or may not favor a bar.
- (7) *The Defendant's Use of Stealth and Concealment*: There are no facts suggesting that the defendant absconded with funds or altered financial documents. This favors denial of a bar.
- (8) *The Defendant's History of Business and Related Misconduct*: Besides the ongoing nature of the fraudulent misconduct, the defendant does not have any prior history of violations. This may or may not favor a bar.
- (9) *The Defendant's Acknowledgement of Wrongdoing and the Credibility of His Contrition*: The defendant admitted his role in the scheme and conceded that it was fraud, but there are no facts to show defendant's contrition. This may or may not favor a bar.

If the nine factors in Professor Barnard's test are considered disjunctively, a court may find the defendant unfit to serve as a corporate fiduciary of a public company. Nevertheless, if courts apply Professor Barnard's suggestion that the SEC must *also* show that the defendant is likely to engage in future misconduct unless barred, the nine-factor test

essentially merges with the holding in *Patel*, and the end result of Sarbanes-Oxley amendment would be nothing more than a transformation of the six-factor test into a nine-factor test.

The purpose of this comparison is to show that neither the six-factor test nor the nine-factor test presents a problem so long as the court is free to consider each factor disjunctively and exercise its discretion in determining the defendant's fitness to serve. Requiring the courts to make a positive finding of the defendant's likelihood of recurrence, or elevating any other particular factor above the others will always present a problem. It is precisely that problem that Congress sought to rectify in Sarbanes-Oxley. If the SEC can establish that the defendant is likely to engage in future violations, it could easily obtain an officer and director bar as a form of ancillary injunctive relief, and the officer and director bar statutes would be unnecessary. For the officer and director bar statutes to be effective, the test for "unfitness" must be flexible enough to apply to the wide range of possible acts of securities fraud.

#### CONCLUSION

Congress amended the officer and director bar statutes in Sarbanes-Oxley in an effort to increase the accountability of corporate managers who engage in securities fraud. The Sarbanes-Oxley legislative history indicates Congress's intent to overrule prior case law and invite courts to establish a more flexible standard for determining when an officer and director bar is appropriate. This Note suggests that courts continue to adhere to a variation of the six-factor test applied in those early cases and apply the factors disjunctively. Unlike those cases overruled by Sarbanes-Oxley, the test proposed by this Note does not require courts to establish the defendant's likelihood of future violations or any single factor of "unfitness" in particular before imposing a bar. Rather, the proposed test encourages courts to consider a wide range of aggravating factors, as well as a positive finding of securities fraud, before determining that an officer and director bar is appropriate.