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FORM OVER SUBSTANCE?: OFFICER CERTIFICATION AND THE PROMISE OF ENHANCED PERSONAL ACCOUNTABILITY UNDER THE SARBANES-OXLEY ACT

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The theme of personal accountability for corporate managers has emerged as a mantra in the wake of the recent allegations of securities fraud associated with the disclosure documents of several major public companies. Over the past year, dozens of public companies have admitted to filing disclosure documents with the Securities and Exchange Commission (the "SEC") that contained significant accounting inaccuracies.¹ These inaccuracies forced such companies to restate their earnings, wiping out millions of dollars in profits, and triggering employee lay-offs, shareholder losses, and in some cases, bankruptcy.² The magnitude of the errors led to charges that such corporations had engaged in securities fraud by deliberately manipulating their financial statements and related information.³ Subsequent investigations suggested that corporate

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1. *See infra* Part IA (discussing accounting and securities fraud allegations relating to Enron, WorldCom and other major public companies).

2. *See id.*

3. *See id.* (describing SEC and Department of Justice Investigations related to certain companies). *See also In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 435-38 (S.D. Tex. 2002) (regarding shareholder suit against directors and officers of Enron alleging securities fraud relating to restatement of company's financial statements); *In re MCI WorldCom, Inc. Sec. Litig.*, 191 F. Supp. 2d 778, 780-81 (S.D. Miss. 2002) (discussing securities fraud suit alleging misrepresentations as to financial conditions of a major company); *In re Xerox Corp. Sec. Litig.*, 165 F. Supp. 2d 208, 211-212 (D. Conn. 2001)

managers either were intimately involved with such manipulation, or failed to monitor appropriately those who were involved.⁴ These investigations also suggested that current law failed to hold corporate officers personally responsible and accountable for the affairs of the corporations they govern.⁵ In the legislature's view, this failure enabled many corporate officials to acquiesce, if not participate, in fraudulent securities practices without fear of personal liability.

Attempting to remedy this failure, Congress recently enacted the Sarbanes-Oxley Act of 2002 (the "Sarbanes Act").⁶ President George W. Bush claims that the law ushers in a "new ethic of personal responsibility in the business community."⁷ One provision of the Sarbanes Act, appearing to exemplify this ethic, requires chief executive officers ("CEOs") and chief financial officers ("CFOs") of every public company to personally certify the accuracy of their company's financial statements,⁸ and imposes criminal sanctions on officers who fail to properly make such certification.⁹ Supporters of this certification believe that it will ensure that corporate officials personally account for financial information related to their companies.¹⁰ As the President proclaimed, "[w]hen you sign a

(regarding securities fraud suit against corporation and executive officers regarding disclosures related to restructuring of company operations); *In re Rite Aid Corp. Sec. Litig.*, 139 F. Supp. 2d 649, 651-55 (E.D. Pa. 2001) (describing securities fraud allegations against former CEO and CFO of Rite Aid).

4. See *infra* Part IA (discussing congressional investigation and committee reports describing inattentiveness of corporate directors and high-level corporate officials). See *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, Feb. 1, 2002, at 148-172 [hereinafter *Enron Special Report*] available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf> (last visited Dec. 15, 2002) (describing Enron board and management's failure to oversee questionable transactions, as well as their failure to properly execute control mechanisms).

5. See *infra* Part IB (noting perceived inadequacies of securities laws).

6. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, (codified in scattered section of 15 U.S.C.). The Act is named after its principal sponsors, Senator Paul Sarbanes, then-chairman of the Senate Committee on Banking, Housing and Urban Affairs, and Congressman Michael Oxley, chairman of the House Committee on Financial Services.

7. President Bush's Speech, July 9, 2002, at www.pbs.org/newshour/bb/business/july-dec02/bush_7-9.html [hereinafter *Bush Speech*] (last visited Dec. 15, 2002).

8. Pub. L. No. 107-204, § 302, 116 Stat. 777-78.

9. Pub. L. No. 107-204, § 906(a), 116 Stat. 806. The penalty enhancement provisions appear under Section 902 of the White-Collar Crime Penalty Enhancement Act of 2002, which amends several of the criminal penalty provisions of the United States Code. See Pub. L. No. 107-204, § 901-906, 116 Stat. 804-06.

10. See *Conference Report on H.R. 3763, Sarbanes-Oxley Act of 2002*, 148 CONG.

statement, you're pledging your word, and you should stand behind it."¹¹ Similarly, the Chairman of the House Judiciary Committee stated that officer certification "will make CEOs directly responsible for the integrity of their company's financial statements."¹² Because officer certification serves as an important symbol of the Sarbanes Act's goal of ensuring personal responsibility among corporate officers, analyzing its potential impact represents an ideal vehicle for exploring the extent to which the Sarbanes Act can meet its goal.

However, this Article argues that the personal certification requirement may not progress beyond the symbolic. Indeed, the SEC has explained that a personal certification requirement does not alter the existing law related to officer liability for a company's financial statements.¹³ Review of the case law appears to support this explanation.¹⁴ Yet if the current climate serves as any indicator, the

REC. H5463 (daily ed. July 25, 2002) (statement of Rep. LaFalce) [hereinafter *Conference Report*] (noting that the certification requirements "will ensure that executives will no longer be able to evade responsibility for the numbers that their companies put out, . . . [and] will help ensure that they are held responsible if they seek to mislead and defraud investors."); *id.* (statement of Rep. Baker) ("Today we bring an end, I believe, to those [corporate] abuses. You must sign that statement, and if you sign it and it is not accurate, there are consequences. If you misrepresent the material facts of your corporation, if you lie about what is going on, there are criminal consequences for that misrepresentation. If you choose simply not to tell the truth, there are consequences for that misrepresentation."); *id.* at H5466 (statement of Rep. Waters) ("This bill will make corporate CEOs and others responsible. They will have to sign the financial statements, and they will have to take responsibility."). The SEC, which proposed its own certification requirement, claimed that its proposal was "consistent with President Bush's objective to make corporate leaders more accountable to the investing public." *Certification of Disclosure in Companies' Quarterly and Annual Reports*, Exchange Act Release No. 34-46079, 67 Fed. Reg. 41877, 41877 n.14 (June 20, 2002) [hereinafter *Disclosure Certification*].

11. See *Bush Speech*, *supra* note 7.

12. *Corporate Fraud Sarbanes Act of 2002*, 148 CONG. REC. H4684-85 (daily ed. July 16, 2002) (statement of House Judiciary Chairman F. James Sensenbrenner, Jr.) (noting that the current corporate "shenanigans" began during the 1990s, "the decade when personal accountability and responsibility became irrelevant").

13. See *Disclosure Certification*, 67 Fed. Reg. at 41878-79 (noting that "[e]xisting antifraud law, as well as the disclosure rules governing documents . . . submitted to the Commission, already place responsibility for the accuracy and completeness of disclosure, and liability for failure to satisfy disclosure requirements, on corporate management and directors").

14. See, e.g., *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061-63 (9th Cir. 2000) (finding that a corporate official who signs a financial report with scienter, does make a statement within the meaning of Section 10(b), and can be held liable for that statement); *Sheehan v. Little Switzerland, Inc.*, 136 F. Supp. 2d 301, 312-14 (D. Del. 2001) (CEO and CFO who signed the 10-K acting with scienter can be held personally liable for misstatements within the 10-K); *SEC v. Enters. Solutions, Inc.*, 142 F. Supp. 2d 561 575-76 (S.D.N.Y. 2001) (finding that a CEO could be personally liable under Rule 10b-5 for signing a financial statement he knew to be misleading); *SEC v. Chester Holdings, Ltd.*, 41 F. Supp. 2d 505, 522-27 (D.N.J. 1999) (CEO and president

existing law has not served to promote personal responsibility among corporate officers. This conclusion provides cause for pessimism about the new certification's potential to meet its goals. This Article reveals that this pessimism may be warranted.

This Article begins with an examination of the incidents that led to the perceived need for procedures to ensure the personal responsibility of corporate executives, and the manner in which the Sarbanes Act's new certification seeks to meet that need. Part I also explores the manner in which the existing signature requirements for disclosure documents containing financial information appears to negate personal responsibility on behalf of corporate officers. Part II contrasts the sources of liability under the new certification with the liability imposed under pre-existing signature requirements. This contrast reveals that while the new certification appears to impose a significantly different standard of corporate responsibility and liability than the existing regime, that appearance may be deceiving. This Article argues that the new certification does relatively little to alter the legal responsibility, and potential liability, that corporate officers may face for accounting and other inaccuracies within their company's financial statements. Part III analyzes the possible rationales behind the current regime's failure to encourage personal responsibility among corporate executives, and the extent to which such failure may continue under the new act. In fact, while the new certification itself may not change the existing standard of liability, the internal monitoring mechanism required under the Sarbanes Act may broaden the scope of an officer's implied knowledge, enhancing the possibility that such officer will be held personally liable for corporate misdeeds. Part IV offers a conclusion about whether this possibility can be achieved.

I. SECURITIES FRAUD AND THE QUEST FOR PERSONAL ACCOUNTABILITY

A. *Asleep at the Switch? The Corporate Officers' Role in Recent Securities Violations*

In order to understand the desire for corporate responsibility through personal certification, we must briefly examine the corporate governance "scandals" that spurred that desire. While this Article will not repeat the lengthy accounts of such scandals,¹⁵ this section

who signed numerous reports filed with the SEC without a genuine belief in their accuracy could be held liable for securities fraud); *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1255-56 (S.D.N.Y. 1996) (corporate officials can be held personally liable for misstatements in a 10-K that they signed).

15. In a five part series entitled "The Fall of Enron," the Washington Post

briefly will discuss the scandals, their impact, and the manner in which they shaped legislators' understanding of the inadequacies within our corporate governance system.

Recently several public companies have announced accounting inaccuracies within the financial statements they filed with the SEC, causing such companies to dramatically restate their earnings.¹⁶ In October of 2001, Enron Corp. ("Enron") announced that it had to restate its earnings as a result of an "accounting error," leading to a

examined in-depth the collapse of Enron, which the Post referred to as "one of the largest, most dramatic corporate failures in U.S. history . . ." *The Fall of Enron*, WASH. POST, July 28, 2002, at A16; see also Peter Behr & April Witt, *Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured its Demise*, WASH. POST, July 28, 2002, at A1 (introducing first of five part series detailing the various financial transactions leading to Enron's rise and ultimate collapse); April Witt & Peter Behr, *Dream Job Turns Into a Nightmare: Skilling's Success Came at High Price*, WASH. POST, July 29, 2002 at A1 (second in five part series detailing events in August 2001 related to the fall of Enron's stock price and its growing debt burden); Peter Behr & April Witt, *Concerns Grow Amid Conflicts: Officials Seek to Limit Probe, Fallout of Deals*, WASH. POST, July 30, 2002, at A1 (third of five part series detailing Enron's activities in September 2001 related to preliminary internal investigation into Enron accounting problems); April Witt & Peter Behr, *Losses, Conflicts Threaten Survival: CFO Fastow Ousted in Probe of Profits*, WASH. POST, July 31, 2002, at A1 (fourth of five part series detailing events in October 2001 related to Enron's declaration of \$1 billion in losses) [hereinafter *Enron Conflicts*]; Peter Behr & April Witt, *Hidden Debts, Deals Scuttle Last Chance*, WASH. POST, Aug. 1, 2002 at A1 (last of five part series detailing Enron's disclosure of additional losses and final declaration of bankruptcy) [hereinafter *Enron Hidden Debts*].

16. Many believe that questionable accounting practices triggered the fall of "dot-com" companies at the end of the 1990s. See, e.g., David S. Hilzenrath, *Puffing Up Performance?: Accounting of Sales by Dot-Coms, Other Companies Increasingly Troublesome to Regulators*, WASH. POST, March 19, 2000, at H1 (noting concerns about the manner in which dot.com and other companies account for their revenue); Mark Leibovich, *Once Defiant, Microstrategy Chief Contritely Faces SEC*, WASH. POST, Jan. 8, 2002, at A1 (describing company restatement that turned two years of profits into two years of losses and the fact that then SEC Chairman Arthur Levitt Jr., had placed a high priority on corporate accounting standards); Christopher H. Schmitt & Paula Dwyer, *Did the Auditors Cross the Line?: The SEC has Tough Questions for Microstrategy and PNC*, BUS. WK., Sept. 25, 2000 at 168 (noting that accounting errors caused the company to restate \$66 million in revenue from 1997-1999, "wip[ing] out \$55.8 million in earnings"). Also, prior to Enron, several other major companies were forced to admit that they had overstated profits. See Kathleen Day & Albert B. Crenshaw, *SEC, Accounting Firms Redrafting Audit Rules: Agency Chairman Draws Fire for Role in Effort*, WASH. POST, Jan. 16, 2002, at A1 (noting that in the late 1990s major companies including Sunbeam Corp. and Waste Management, Inc. admitted to overstating profits); Sandra Sugawara, *U.S. Files Charges, Lawsuit in Accounting Fraud Scheme*, WASH. POST, Sept. 29, 2000, at E4 (describing accounting fraud scam at McKesson HBOC Inc, the nation's largest pharmaceutical drug wholesaler, that wiped out \$9 million, and describing federal authorities belief that many more companies "may be cooking the books to meet analysts' expectations").

\$1.2 billion reduction in shareholder value.¹⁷ In November 2001, Enron disclosed more accounting errors, forcing the company to renounce nearly \$600 million in profits.¹⁸ Some politicians and business leaders, including Enron executives, sought to characterize Enron, and its accounting troubles, as a one time, insulated incident.¹⁹ Indeed, many claimed that corporations and corporate officials who engaged in accounting violations represented a “few bad apples.”²⁰

However, by the summer of 2002 the problem of inaccurate accounting disclosures appeared to be widespread as erroneous financial statements forced dozens of public companies to restate their earnings.²¹ For example, in June 2002, Xerox Corp. (“Xerox”) announced a \$6.4 billion restatement three months after settling a claim with the SEC alleging that it used fraudulent accounting practices to improve its financial results from 1997 to 2001.²² In that

17. See Margot Williams & Lucy Shackelford, *The Downward Spiral: November 2001*, WASH. POST, Aug. 1, 2002, at A16. On October 16, 2001, Enron announced a \$544 million loss for its third quarter, triggering the \$1.2 billion loss to shareholder value. *Id.*

18. See *id.* at A16. On November 8, 2001, Enron announced that it had overstated its earnings by \$586 million and had to restate profits going back four years. *Id.*

19. In the months after it declared bankruptcy, the U.S. Chamber of Commerce characterized Enron as a “rogue corporation.” Steven Pearlstein, *Debating the Enron Effect: Business World Divided on Problem & Solutions*, WASH. POST, Feb. 17, 2002, at A1. Indeed, the head of the Chambers of Commerce described Enron as “an unfortunate and dramatic exception to” an otherwise transparent disclosure system. *Id.* However, others, including then SEC Chairman Arthur Levitt, believed that Enron’s troubles grew out of a system-wide culture focused on stock prices and earnings. *Id.* Although the chief accounting officer of Enron tried to characterize Enron’s losses as “one-time and non-recurring,” partners at Arthur Andersen, Enron’s outside auditors, objected to the phrase, claiming that the losses were indications of a more deep-rooted problem with the company as a whole. See *Enron Conflicts*, *supra* note 15 at A8.

20. *Morning Edition*, NPR Radio Broadcast, July 23, 2002, available at 2002 WL 3188885 (quoting John J. Castellani, President of the Business Roundtable); see also Steven Pearlstein, *In Blossoming Scandal, Culprits are Countless*, WASH. POST, June 28, 2002, at A1 (citing Harvard Business School Professor Jay Lorsch as among those who referred to corporate officials engaged in fraud as a “few rotten apples”); Lynn E. Turner, *Just a Few Rotten Apples? Better Audit Those Books*, WASH. POST, July 14, 2002, at B1 (citing President Bush as referring to corporate officials as a “few bad apples”).

21. According to a study by the Huron Consulting Group, in 2001, 270 public companies restated their numbers, a record high. Turner, *supra* note 20, at B1. Such restatements were more than three times those released in 1997. See Anitha Reddy, *Restating, for the Record: Va. Ties Highest Rate of Changes to Financial Statements*, WASH. POST, July 8, 2002, at E1 (noting that Virginia and Massachusetts had the highest number of financial restatements in 2001).

22. Kathleen Day, *Xerox Restates 5 Years of Revenue: '97-'01 Figures Were Off By \$6.4 Billion*, WASH. POST, June 29, 2002, at A1. After the SEC filed a complaint

same month, a federal grand jury indicted the former CEO of Rite Aid Corporation, America's third largest drugstore chain ("Rite Aid"), on charges stemming from the company's 1999 corporate restatement that erased \$1.6 billion in profits.²³ In July 2002, Qwest Communications International, Inc., the dominant local phone provider in 14 states ("Qwest"), announced that it incorrectly had booked as much as \$1.16 billion in earnings.²⁴ That same month, federal authorities arrested five former executives of Adelphia Communications Corp., the sixth largest provider of cable television services ("Adelphia"), based on allegations that Adelphia deliberately underestimated its debt by \$3 billion.²⁵ Also in July 2002, the SEC charged top officials at WorldCom, Inc. ("WorldCom") with devising an accounting scheme designed to hide \$3.9 billion in losses.²⁶ About

against Xerox in April, the company agreed to a settlement without admitting to any wrongdoing. *See id.*; *see also* Kathleen Day, *Xerox Admits Nothing but Will Pay \$10 Million Fine*, WASH. POST, April 12, 2002, at E2. Under the settlement, Xerox agreed to pay a \$10 million fine, the largest ever involved in fraudulent reporting, and agreed to review its finances, which resulted in a restatement announcement more than two times that of the \$3 billion anticipated by the SEC. *See id.*

23. *See* David S. Hilzenrath, *Former Rite Aid Officials Indicted: U.S. Says Executives Inflated Profits, Diverted Funds*, WASH. POST, June 22, 2002, at A1. At the time Rite Aid issued its restatement, it was the largest earnings correction in U.S. history. *Id.*; *see also* Frank Ahrens, *History of Conflict for Ex-Rite Aid Chief: Indictment Paints Picture of Grass as an Arrogant Bully*, WASH. POST, June 22, 2002, at E1.

24. Anitha Reddy, *Qwest Move Puts Focus on Trades*, WASH. POST, July 30, 2002, at E1 (noting that Qwest had to restate its earnings as a result of the practice of trading communications capacity to build networks—a practice that is widespread within the telecommunication's industry).

25. *See* Carrie Johnson & Christopher Stern, *Adelphia Founder, Sons Charged: Family Looted Sixth-Largest Cable TV Company, U.S. Says*, WASH. POST, July 25, 2002, at A1. Federal authorities claimed that company officials used "accounting tricks" to inflate company earnings and hide its debt. *Id.* In a dramatic display, Postal Service Inspectors, who had initial jurisdiction over the case because the company allegedly mailed fraudulent financial statements to shareholders, arrested three executive officers of Adelphia at their apartment, and took them away in handcuffs. *See id.*

26. *See* Kevin Maney, *Latest Charges Leave WorldCom in Limbo: Company, Former CEO Ebbers Could be Next on Fed's List*, USA TODAY, Aug. 2, 2002, at 1B. As a result of the scheme, WorldCom had to restate its earnings for 2001 and the first quarter of 2002. *Id.* Indeed, the scheme wiped out all of the company's profits for 2001. *See* Yuki Noguchi & Renae Merle, *WorldCom Says Its Books Are Off By \$3.8 Billion; U.S. Criminal Probe Reported*, WASH. POST, June 26, 2002, at A1 (anticipating WorldCom restatement "to be the largest in business history," encompassing five quarters). In addition, WorldCom's chief financial officer and controller were arrested in connection with fraud allegations. *See* Renae Merle, *Sullivan Rose By the Numbers: Deals, Detail Pushed Career at WorldCom*, WASH. POST, Aug. 2, 2002, at E1 (detailing the career of former WorldCom CFO Scott Sullivan, which culminated in his "handcuffed stroll before the cameras and into custody"); Carrie Johnson & Ben White, *WorldCom Arrests Made: Two Former Executives Charged With Hiding Expenses*,

two weeks later, WorldCom announced an additional \$3.8 billion loss related to accounting errors, doubling its previous announcement to more than \$7.6 billion in losses.²⁷ In August 2002, the SEC and the Department of Justice announced investigations into the accounting practices of AOL Time Warner, Inc. ("AOL").²⁸ A few weeks later, AOL announced that it had inappropriately recognized \$49 million in revenue.²⁹ As one U.S. senator proclaimed, the list of companies engaged in "lies about income and profit" is not only long, but is "painful in part because it includes some icons of American business."³⁰

The virtual wave of accounting restatements had a devastating impact on the companies involved, their creditors, shareholders, and

WASH. POST., Aug. 2, 2002, at A1 (noting arrest of both the chief financial officer and former controller "for allegedly hiding \$3.9 billion in expenses through accounting scheme").

27. See Christopher Stern, *WorldCom Auditors Find More Errors: \$3.8 Billion Added to Earlier Total*, WASH. POST, Aug. 9, 2002, at A1 (errors stemmed from the improper treatment of reserve accounts in order to inflate revenues in 1999, 2000 and 2001). The announcement meant that "WorldCom may have the largest corporate fraud in history." See *id.*

28. See Alec Klein, *SEC Expands Probe of AOL: Query Targets Deals with PurchasePro*, WASH. POST, Aug. 2, 2002, at E1 (noting expansion of investigation into AOL's "business relationship with a Las Vegas software firm"); Alec Klein & Dan Eggen, *U.S. Opens Criminal AOL Probe: Justice Dept. to Focus on Unusual Accounting*, WASH. POST, Aug. 1, 2002, at A1 (noting Justice Department's focus on on-line business division based in Dulles); David Lieberman and Paul Davidson, *AOL: Justice Scrutinizing Accounting Giant Confirms Probe*, USA TODAY, Aug. 1, 2002, at B1 (stating that "the Justice Department is investigating accounting practices of America Online").

29. See Frank Ahrens, *AOL Discloses Revenue Errors: \$49 Million From Ad Deals Misbooked, Firm Tells SEC*, WASH. POST, Aug. 15, 2002, at A1. AOL claimed that the amount, which related to commerce and advertising revenue, represented an insignificant portion of the company's revenues during the reporting period. *Id.*

30. *The Need to Enact Accounting and Corporate Reforms*, 148 CONG. REC. S651-6564, (daily ed. July 10, 2002), (statement of Sen. Levin) (citing various companies engaged in corporate malfeasance). Indeed, the SEC announced plans to charge Warnaco, the maker of Calvin Klein Jeans and underwear and Speedo swimsuits with securities laws violations stemming from accounting errors that led to overstating profits and understating "losses by \$51 million between 1999 and early 2001". Noelle Knox, *Warnaco Latest to Face Securities Charges: Apparel Maker's Accounting Practices Under Investigation*, USA TODAY, Aug. 2, 2002, at B1. The problems forced the company into bankruptcy. See *id.* In June 2002, Tyco International Ltd. ("Tyco") sued its general counsel based on allegations regarding his failure to disclose \$35 million in assets. See, e.g., Jeff Krasner, *Tyco Sues 2 Former Officials: Executives Accused of Pay Impropriety: A Coverup Alleged*, BOSTON GLOBE, June 18, 2002, at D1. The SEC is also investigating Tyco relating to allegations that the former CEO, who was indicted in New York, evaded \$1 million in sales tax. See, e.g., Jeffrey Krasner, *SEC Launches Formal Probe of Tyco*, BOSTON GLOBE, June 13, 2002, at E1; Mark Maremont et al., *Probe of Ex-Tyco Chief Focuses on Improper Use of Company Funds*, WALL ST. J., June 6, 2002, at A1.

employees. While other company's constituents were dealt a blow,³¹ Enron and WorldCom reflect the most publicized example of that impact. Enron's accounting errors caused it to declare "the largest bankruptcy petition in history," seeking "to forestall payment on \$31.2 billion in debt."³² Unfortunately, nearly six months later, WorldCom filed bankruptcy on \$41 billion in debt, eclipsing Enron as the largest bankruptcy case ever filed.³³ These filings left many creditors unable to seek full repayment for their loans.³⁴ Moreover, these companies' actions proved devastating for shareholders and employees alike. Thus, Enron shareholders lost \$179.3 billion, while WorldCom shareholders lost over \$66 billion.³⁵ Then too, over 17,000 employees lost their jobs at WorldCom, while Enron's collapse meant that the company laid-off more than 6,000 employees.³⁶ Months after their termination, many of these employees had yet to find new jobs.³⁷ In addition to their jobs, such employees lost the bulk of their retirement savings.³⁸

Allegations of accounting errors and fraud also had an impact on

31. For example, Qwest stock, as high as \$27 in the past year, closed at \$1.49 at the end of July, representing millions of dollars in shareholder loss. See Reddy, *supra* note 21, at E3. Adelphia also declared bankruptcy as a result of its restatement. See Johnson & Stern, *supra* note 25, at A1.

32. Peter Behr, *Ailing Enron Files for Chapter 11 Bankruptcy Protection*, WASH. POST, Dec. 3, 2001, at A1. On December 2, 2001, Enron filed the largest bankruptcy petition in U.S. history. *Id.*

33. See Andrew Backover, *2 Former WorldCom Executives Charged in Scandals: Ashcroft Says Arrests are Message to Those Who Betray Investors*, USA TODAY, Aug. 2, 2002, at 1A (noting bankruptcy case filed on July 21, 2002).

34. One of Enron's biggest lenders, J.P. Morgan, announced \$456 million in losses related to Enron's collapse. See Robert O'Harrow, Jr., *Enron's Impact on Banks Grows: JP Morgan Chase Takes \$456 Million Hit; Citigroup's Toll Likely Large*, WASH. POST, Jan. 17, 2002, at E1; Ben White, *Traders Edgy About Morgan Chase Loans*, WASH. POST, Feb. 15, 2002, at E1. Citigroup, another Enron creditor, announced \$228 million in losses associated with Enron. See Robert O'Harrow, Jr., *Citigroup Prospers Despite Problems: Profits Up 36% in 4th Quarter*, WASH. POST, Jan. 18, 2002, at E3.

35. See John A. Byrne, *Fall From Grace*, BUS. WK., Aug. 12, 2002, at 51.

36. See *id.*

37. See Stephanie Armour, *Laid-off Workers Still Feel Fallout: Some Cite Stigma of Having Worked for Such Companies as Enron*, USA TODAY, Aug. 1, 2002, at 3B (noting that many employees are still looking for jobs and that others either must hide their former employment record in order to secure a job in their field or work for salaries dramatically lower than their previous ones). According to the article, "[a]n informal poll by EnronX found that about 40% of those laid off are still looking for work." *Id.*

38. See Amy Joyce, *Study Shows 401(k) Vulnerability*, WASH. POST, July 13, 2002, at E2 (citing Congressional Research study showing that more employees "have a higher concentration of their company's stock" in retirement accounts). Such a practice means that employees lose the bulk of their retirement when a company's stock collapses as in the case of Enron and WorldCom, where retirement plans lost at least \$1.1 billion in assets. See *id.*

the nation as a whole. Indeed, questions relating to accounting discrepancies triggered large drops in the stock market.³⁹ In July 2002, as the announcements regarding corporate accounting schemes grew, the S&P 500 experienced its steepest July drop in more than 50 years.⁴⁰ In the same month, the U.S. consumer confidence index experienced its biggest decrease since the terrorist attacks on September 11.⁴¹ Many explained the plummeting stock market as an indicator of Americans' decreasing confidence in accurate financial reporting, and the stock market in general.⁴²

39. See Michael Barbaro, *Markets Surge in Shortened Trading: Dow Has Biggest One Day Gain of Year; Nasdaq Up 4.9%*, WASH. POST, July 6, 2002, at E1 (noting analysts belief that concern over terrorist attacks, corporate credibility and accounting irregularities caused "a week of staggering losses" followed by the largest one day gain); E.S. Browning, *Nasdaq Drops 3% on Latest Uncertainties*, WALL ST. J., Feb. 20, 2002, at C1 (noting that uncertainties relating to corporate misconduct triggered stock decline); Ben White, *Fears Over Accounting Tactics Drag Down Stocks*, WASH. POST, Jan. 30, 2002, at E3 (noting that "concern about corporate accounting practices triggered a wave of selling . . . sending the Dow Jones industrial average down 2.5 percent, its biggest drop in three months").

40. The S&P fell 7.9% in July 2002. See Adam Shell, *S&P 500 Index Sweats Through 8% Loss in July: Biggest Drop in About 50 Years, but Hope Grew Wednesday*, USA TODAY, Aug. 1, 2002, at 1B.

41. See *Confidence Takes a Hit*, WASH. POST, July 31, 2002, at E2.

42. See Pearlstein, *supra* note 19, at A24. See also Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1 ("[T]he sheer scope and apparent audacity of the misrepresentations at WorldCom served to punctuate investors' sense of unease about the reliability of corporate financial reporting, helping to send the stock market into a virtual free fall for several days until it touched five-year lows."); Steven Pearlstein, *Measures Not Likely to End Abuses*, WASH. POST, July 10, 2002, at A1 (citing Gallup Poll finding that six out of ten investors claimed corporate and accounting fraud made them reluctant to invest in the stock market). Indeed, the Conference Report on the Sarbanes Act is replete with references to investor's loss in confidence spawned by the corporate scandals. See *Conference Report*, 148 CONG. REC. at H5466-H5467 (statement of Rep. Bentsen) ("The recent declines in the U.S. equity markets are due in large part and have been exacerbated by the breakdown in corporate governance, and a lot of the shenanigans, quite frankly, that has been going on in corporate America, whether it is Enron, WorldCom, Adelphia, Xerox, you name it."); see *id.* at H5467 (statement of Rep. Roukema) (noting the "crisis of confidence in our economic system" and that "over the last few months our economy has been damaged by the drip-drip-drip of newspaper stories, television accounts and press releases recounting the latest corporate accounting scandal, revenue over-projection, financial irregularity or out-and-out "cooking of the books" by our captains of industry."); *Id.* at H5472 (statement of Rep. Jackson-Lee) (describing the "roll call of corporate failures in America," and that such failures undermine investor confidence in our capital markets); *Id.* at H5474 (statement of Rep. Etheridge) (noting that America's trust in the stock market has been "sorely tested," and the plunging stock market is a clear indicator of investor fears.); *Id.* at H5477 (statement of Rep. Blumenauer) ("Like families nationwide who have seen investment savings deteriorate and have lost confidence in our markets and business leaders, I have been concerned with revelations about inaccurate corporate accounting and inappropriate and in some cases illegal corporate practices.").

Legislators and the public believed that many of the accounting inaccuracies stemmed from deliberate manipulation, and thus constituted securities fraud. Hence, the Department of Justice, the SEC, and shareholders began bringing actions against corporations and their officers for violation of securities and other related laws.⁴³

While legislators and the public blamed the accounting industry for much of the corporate malfeasance,⁴⁴ they also faulted corporate executives who either appeared to deliberately engage in the fraudulent activity or failed to monitor those who did.⁴⁵ Indeed, where were the corporate executives and board members charged with monitoring the affairs of the company? It appears they were either manning the wheel or asleep at the switch. The arrests of several top-level executives implies that many corporate executives were intimately involved with manipulating accounting figures in order to hide millions, and sometimes billions, of dollars in losses.⁴⁶

43. See *supra* note 3 and accompanying text (pinpointing shareholder suits); *supra* notes 22-30 and accompanying text (describing actions by the SEC and the Department of Justice).

44. See, e.g., 148 CONG. REC. at S6563 (statement of Sen. Levin) (noting Arthur Andersen's role at Enron and citing the "terrible performance of too many in the accounting profession" as one explanation for corporate misconduct); see also Kurt Eichenwald, *Early Verdict on Audit: Procedures Ignored*, N.Y. TIMES, June 6, 2002, at C6 (describing Andersen's role in Enron as representing a fundamental breakdown of internal procedures). Indeed, Enron's collapse spurred the collapse of accounting giant Arthur Andersen, which dissolved after being found criminally liable for obstructing justice. See Carrie Johnson and Peter Behr, *Andersen Guilty of Obstruction; Accounting Firm Will End Audit Work*, WASH. POST, June 16, 2002, at A1. The charge represented the first major accounting firm ever convicted of a felony. *Id.* Andersen will be sentenced on October 11, 2002. *Id.*

45. See *Enron Special Report*, *supra* note 4, at 217; *The Need for Accounting Reform*, 148 CONG. REC. at S6564 (statement of Sen. Levin, chairman of Permanent Subcommittee on Investigations) (noting that board failed to safeguard Enron shareholders and contributed to Enron's collapse).

46. On October 3, 2002, the federal government charged Andrew Fastow, Enron's former CEO, with helping to manipulate Enron's financial statements. See Staff Writers, *Case Against Fastow Points Higher: Complaint Seen as Foundation for Prosecution of Top Enron Executives*, WASH. POST, Oct. 3, 2002, at E1. Prosecutors expect that such charges will serve as a foundation to bring suit against other top Enron executives, such as Jeffrey Skilling and Kenneth Lay, for fraudulent activity. See *id.* Along these lines, prosecutors expect that they will be able to use a guilty plea from Michael J. Cooper, a former Enron officer, to build a case against Jeffrey Skilling and other Enron officers. See, e.g., Carrie Johnson, *Enron Officials Assets Frozen; Fastow, Family Are Targets of Court Move*, WASH. POST, Aug. 24, 2002, at A1; Carrie Johnson, *Ex-Enron Official Will Plead Guilty; First Case Against A Company Executive*, WASH. POST, Aug. 21, 2002, at A1 (discussing impact of expected guilty plea from Michael Kopper, a former director in Enron's global finance unit). Other corporate executives allegedly involved in accounting scams were Scott Sullivan, the CEO of WorldCom, see Backover, *supra* note 33, at 1A, and Martin Grass, the CEO of Rite Aid, see Hilzenrath, *supra* note 16, at A1.

Investigations also allege that other corporate managers knew about questionable practices, but chose to ignore red flags.⁴⁷ In this way, corporate officials' actions may have deliberately or recklessly caused losses to shareholders and employees.

However, even those corporate officials who denied being involved in fraudulent activities appeared to engage in rubber-stamping of corporate documents at odds with their corporate monitoring role.⁴⁸ Indeed, corporate law not only holds directors and officers responsible for the affairs of the corporations they govern, but also imposes upon them a duty to monitor and pay attention to those affairs. Thus, as a matter of corporate fiduciary law, such directors and officers breach their duty of care when they fail to pay sufficient attention to financial or other business affairs.⁴⁹ Federal securities laws also impose a duty on directors and executive officers to conduct a reasonable inquiry into the business and financial affairs of the company, including an appropriate inquiry of those responsible for preparing financial data.⁵⁰ The recent allegations

47. Indeed, the Permanent Subcommittee on Investigations concluded that the Enron board "knew about numerous questionable practices by Enron management over several years, but it chose to ignore red flags." *The Need for Accounting Reform*, 148 CONG. REC. at S6564 (statement of Sen. Levin, chairman of Permanent Subcommittee on Investigations); see also Johnson, *supra* note 46, (discussing prosecutor's intent to pursue charges against former Enron CFO Fastow and CEO Skilling using Kopper's testimony).

48. See, e.g., Carrie Johnson, *Enron Board Aided Collapse Senate Panel Says; Report Finds Directors Approved Conflicts of Interests, Large Cash Bonuses*, WASH. POST, July 7, 2002, at A10 (citing Senate report concluding that Enron board members contributed to the firm's collapse by failing to curb fraudulent accounting practices and rubber stamping conflict of interest transactions).

49. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (holding directors liable to investors for uninformed decision related to merger). The Delaware court in *Van Gorkom* concluded that the board "was grossly negligent in that it failed to act with informed reasonable deliberation." *Id.* at 881. The case was settled for \$23,500,000. ARTHUR FLEISCHER, ET AL., BOARD GAMES 37 (1988). See also *Francis v. United Jersey Bank*, 432 A.2d 814, 829 (N.J. 1981) (finding that board director's failure to review company financial statements contributed to shareholder loss related to improper distributions reflected on company's financial statements, and hence director could be held liable for more than \$10 million associated with such loss). The *Francis* court stated, "directors are under a continuing obligation to keep informed about the activities of the corporation," and "they should maintain familiarity with the financial status of the corporation by a regular review of financial statements." See *id.* at 822-23.

50. Under Section 11 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 77k, chief executive and financial officers who must sign the registration statement, as well as every board member, may be civilly liable for any material misstatement or omission contained with an effective registration statement. Exchange Act § 11, 15 U.S.C. § 77k(2) (1994). Such corporate managers can avoid liability with respect to non-expertised portions (which excludes financial statements of the registration statement) if, after reasonable investigation, he had reasonable

suggest a failure to live up to these duties. Indeed, despite having signed off on their company's financial reports, when called before Congress to explain the reasons behind their company's inaccurate securities and accounting disclosures, many directors and corporate executives claimed to be unaware of the content of their company's financial statements.⁵¹ Those that knew about information contradicting company disclosures claimed to have relied on the advice of accountants and lawyers as to the integrity of their company's financial disclosures.⁵² As the SEC noted, corporate executives' apparent lack of awareness regarding financial data within their company's public reports contributed to the securities fraud violations within their company.⁵³ Moreover, it contributed to the notion that corporate executives lacked any personal accountability for the accuracy of such financial data.⁵⁴

The Sarbanes Act represented Congress' attempt to address this lack. In legislators' views, our laws needed to encourage directors to pay closer attention to financial information and to take personal responsibility for its accuracy. Personal certification appeared an

ground to believe and did believe that the statements were true and not misleading. See Exchange Act, § 11, 15 U.S.C. § 77k(b)(3)(A). With regard to expertised portions such as the financial statements, such managers must prove that they had a reasonable ground to believe and did not believe that the statements were untrue or misleading. Exchange Act § 11, 15 U.S.C. § 77k(b)(3)(C). The seminal case on this section found that in order to avail themselves of this "due diligence" defense, corporate directors must check matters easily verifiable and investigate the accuracy of information within their knowledge. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683-703 (S.D.N.Y. 1968).

51. See *The Need for Accounting Reform*, 148 CONG. REC. at S6564 (noting that Enron board members claimed they didn't know what was going on in the company when pressed to explain their conduct).

52. See *Response of Enron Board to Warning Signs*, BEFORE THE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, May 7, 2002, 2002 WL 20316844 (statement of Dr. Robert K. Jaedicke, Chairman of the Audit Committee of Board of Enron) (noting that Enron paid Arthur Andersen specifically to address accounting issues and that board members relied on Arthur Andersen to make sure that Enron properly accounted for its transactions); see *Hearings on Response of Enron Board to Warning Signs Before the Permanent SubComm. On Investigations of the Senate Comm. On Governmental Affairs*, May 7, 2002, available at 2002 WL 20316843, May 7, 2002 (statement of Harbert S. Winokur, Chairman of the Finance Committee of the Board of Directors of Enron) (noting reliance on accountants and other experts).

53. See *Disclosure Certification*, 67 Fed. Reg. at 41877 (noting that questions have arisen as to whether senior officials devote sufficient attention to their company's financial reports and that the new certification is designed to ensure that such attention among company executives).

54. See *The Need for Accounting Reform*, 148 CONG. REC. at S6564 (noting that the Enron Board accepted no responsibility for Enron's failures); *Enron Special Report*, *supra* note 4, at 166 (claiming that no one in management accepted primary responsibility for oversight).

ideal method of encouragement. Ensuring personal accountability through certification is not a new idea. In fact, the SEC's 1998 "Aircraft Carrier" initiative contained a proposal to broaden the signature requirements on disclosure documents to hold corporate managers personally accountable for all of the forms filed with the SEC.⁵⁵ The proposal failed along with the rest of the initiative.⁵⁶ As securities fraud allegations increased during June 2002, the SEC renewed its request to make certification a permanent feature of the financial reporting system,⁵⁷ while announcing a temporary order for such certification.⁵⁸ For the first time, both Congress and the president overwhelmingly supported such a concept,⁵⁹ and thus incorporated certification into the Sarbanes Act.

Supporters of certification claim that it will hold corporate executives personally liable for misstatements in company financial statements, and that such liability represents a dramatic shift from

55. See Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40632A, Investment Company Release No. 23519A [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,108 (Nov. 13, 1998) [hereinafter Regulation of Securities Offerings]. The proposal would have required that CEOs and CFOs sign certifications related to annual reports on form 10-K and quarterly reports on 10-Q. See *id.* The proposal also would have expanded the number of people required to sign the 10-Q to include the CEO and a majority of the board of directors. Current requirements only require the CFO to sign the 10-Q. See *infra* note 71 (explaining signature instructions). Such a provision would have brought the 10-Q signature requirements in line with existing 10-K requirements.

56. See Regulation of Securities Offerings, *supra* note 55.

57. See Disclosure Certification, 67 FR 41877. Similar to the 1998 proposal, this proposal applies to disclosures made in annual and quarterly reports.

58. The SEC ordered the executives of nearly 1,000 companies to personally certify all of the financial statements their companies filed in 2001. S.E.C. File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, available at <http://www.sec.gov/rules/other/4-460.htm> (last visited Dec. 15, 2002) [hereinafter *SEC Order*]. The order covers 945 companies, which represents companies with revenues greater than \$1.2 billion in the 2001 fiscal year that file reports with the SEC. *Id.* The order requires that the CEO and the CFO make a certification related to the annual report on Form 10-K and the quarterly report on 10-Q filed during the 2001 year, as well as any current reports on Form 8-K and proxy statements filed during that year. SEC Publishes List of Companies Whose Offices are Ordered to Certify Accuracy and Completeness of Recent Annual Reports, (June 28, 2002) available at <http://www.sec.gov/news/press/2002-96.htm> (last visited Dec. 15, 2002) [hereinafter *SEC List of Companies*] (list includes 945 publicly registered companies). The certifications were to be submitted to the SEC by August 15, 2002. *SEC Order* at E6.

59. See, e.g., Anitha Reddy *Few Argue with Pitts Proposal for CEO Accountability*, WASH. POST, June 28, 2002. In his speech to investors and corporate managers on Wall Street, President Bush called for a "new ethic of personal responsibility in the business community" and made certification a key component of his plan to restore personal responsibility within America's corporations. *Bush Speech*, *supra* note 7.

the old regime. Then-SEC Chairman Harvey L. Pitt⁶⁰ called certification “an unprecedented step,” because it requires that CEOs and CFOs “swear that the numbers they’ve reported in their financial reports are correct and that they’ve left nothing important out.”⁶¹ Meanwhile, President Bush made an even bolder proclamation.

My accountability plan also requires CEOs to personally vouch for their firm’s annual financial statements. Currently, a CEO signs a nominal certificate and does so merely on behalf of the company. In the future, the signature of the CEO should also be his or her personal certification of the veracity and fairness of the financial disclosures.⁶²

In this way, certification serves to ensure that corporate officers, particularly CEOs, take personal responsibility for their company affairs.

B. Perceived Inadequacies in Existing Signature Requirements

As President Bush’s statement suggests, lawmakers based the rationale for the new certification on the notion that existing rules failed to hold directors personally responsible for the financial statements that they signed, or for the financial statements their company filed during their tenure. On the surface, this rationale appears sound because the existing rules seem to limit the exposure of officers to certain reports, while the signature format appears to ensure that even officers who sign such reports avoid personal liability for the information contained within them.⁶³

Public companies convey financial and other information regarding their company’s business through various “periodic reports” filed with the SEC.⁶⁴ The Securities Exchange Act of 1934, as

60. On November 5, 2002, just 15 months into his job, Harvey Pitt resigned as chairman of the SEC amidst controversy. See David S. Hilzenrath, *Embattled Pitt Resigns as § Chief; Latest Controversy Cost Him White House Support*, WASH. POST, Nov. 6, 2002 at A1.

61. *SEC List of Companies*, *supra* note 57.

62. See *Bush Speech*, *supra* note 7.

63. See *infra* notes 77-85 and accompanying text (discussing signature requirements for the 10-K and the 10-Q, as well as signatures “on behalf” of the corporation).

64. When referring to periodic reports, this Article will refer only to the 10-K and the 10-Q. However, in addition to the annual and quarterly reports, the Exchange Act also requires companies to file a current report on Form 8-K (the “8-K”) related to certain current events such as changes in control or business combinations of the company, bankruptcy or any events the company deems important. Exchange Act § 13(a), 15 U.S.C. § 78m (2002); 17 C.F.R. § 240.13a-11 (2002). The events to be included on the current report include changes of control, acquisition or disposition of assets other than in the ordinary course of business, bankruptcy or receivership, changes in

amended (the "Exchange Act"),⁶⁵ requires every publicly registered company to file an annual report on Form 10-K (the "10-K") within ninety days after the end of each fiscal year.⁶⁶ The Exchange Act also requires such companies to file quarterly reports on Form 10-Q (the "10-Q") within forty-five days after the end of the first three fiscal quarters of each fiscal year.⁶⁷ Both of these reports include financial information, management discussion, and analysis of that information, as well as financial statements.⁶⁸

Currently, the signature requirements differ for each of the periodic reports filed pursuant to the Exchange Act. Prior to 1980, only the corporation had to sign the 10-K.⁶⁹ However, in 1980, the SEC amended the signature requirements for the 10-K, requiring that not only the corporation, but also the CFO, CEO and at least a majority of the board of directors, sign the 10-K on behalf of the corporation.⁷⁰ By contrast, existing guidelines only require that the CFO and a duly authorized officer sign the 10-Q.⁷¹

the certifying accountant, and other events that the company believes to be important to security holders. In addition, if a director resigns or refuses to stand for re-election because of a disagreement regarding the company's operations, policies or practices, a company must file a current report describing the disagreement. The 8-K may include some financial information. *See* Item 7 to Form 8-K (requiring financial statements and pro forma financial information in connection with reports related to business acquisitions). The Exchange Act also requires public companies to file a proxy statement whenever it solicits shareholder proxies, such as solicitations related to the election of directors. *See* Exchange Act §14, 15 U.S.C. § 78n (1994) (making it unlawful to solicit any proxy or consent or authorization related to any registered security); 17 C.F.R. § 140.14a-1 et seq. (addressing proxy rules). Like the 8-K, the proxy statement also may include financial information. *See id.*

65. *See* 15 U.S.C. §§ 78a-78mm (1994).

66. *See* Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1994); 17 C.F.R. § 240.13a-1. *See also* General Instructions A to Form 10-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,102 at 22,062 (Nov. 15, 2002)

67. *See* Exchange Act § 13(a), 15 U.S.C. § 78m(a), 17 C.F.R. § 240.13a-13. *See also* General Instructions A to Form 10-Q.

68. Regulation S-K governs much of the financial information required to be included in the periodic reports. Particularly, Regulation S-K includes Item 301, 17 C.F.R. § 229.301, regarding selected financial data, Item 302, 17 C.F.R. § 229.302, regarding supplementary financial data, and Item 303, 17 C.F.R. § 229.303, regarding management's discussion and analysis of the company's financial conditions.

69. *See* Amendments to Annual Report Form, Securities Act Release No. 6231, Exchange Act Release No. 17,114, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,301, at 62,812 (Sept. 2, 1980) (amending signature requirement for annual report).

70. *See id.*

71. *See* General Instructions G to Form 10-Q, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,031, at 22,023 (Nov. 15, 2002). Unlike the periodic reports that require a specific officer to sign, existing guidelines allow any duly authorized officer to sign an 8-K. Indeed, General Instructions E to Form 8-K states that the 8-K shall be manually signed, without specifying an officer. *See* General Instructions E to Form 8-K, 5 Fed. Sec. L.

Examining this difference in signing obligations suggests that CEOs can limit their personal exposure, if any, by limiting the number of documents they sign. Under existing guidelines, the CFO has the greatest amount of potential exposure because she must sign both the 10-K and the 10-Q.⁷² In contrast, the CEO has greater flexibility because the Exchange Act only requires her signature on the 10-K. The CEO's ability to avoid signing the 10-Q may significantly reduce her potential liability given that the company must file such reports three times more than the 10-K.⁷³ In this way, the current rules appear to limit the liability of the CEO to the annual report.

Then too, the form of the signature provisions suggests that an officer's signature on a given report does not make her personally responsible for the contents of that report. The signature instructions for all of the periodic reports provide that an officer signs "on behalf" of the corporation.⁷⁴ Such an instruction appears to designate the corporation as liable for the information contained in any form. Moreover, every officer's signature appears next to, or above, his title within the company. This further suggests that the officer is signing in her capacity as an officer of the corporation, and not in her individual capacity. Principles of agency law support the notion that the existing signature scheme does not subject signers to personal liability. As a matter of agency law, an agent who signs a document on behalf of a principal is not personally liable for the obligations within the document.⁷⁵ Principles of agency law generally govern the

Rep. (CCH) ¶¶ 31,002-31,003 at 21,992-21,993 (Nov. 16, 1996).

72. Of course the CFO may opt not to sign the 8-K, even when such reports may include financial information. *Id.*

73. Of course some board members may avoid signing any documents filed with the SEC. Indeed, since only a majority of the board must sign the 10-K, it is entirely possible that reports may be filed without the signature of the chairman of the board or other board members. The current trend in corporate governance has been towards large boards of directors, with many of them being outside directors. Such a trend seems to increase the possibility that many board members may never sign a periodic report.

74. See General Instruction D to Form 10-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,102, at 22,062-22,063 (Nov. 15, 2002); General Instruction G to Form 10-Q, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,031 at 22,023 (Nov. 15 2002).

75. See, e.g., 3A WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1118, at 219-220 (perm. ed., rev. vol. 1994) ("If a corporate officer makes an authorized contract in the name of the corporation, so as to bind the corporation, the contract is with the corporation only, and the other party to the contract cannot hold the officer personally liable. . . ."); *Fink v. Montgomery Elevator Co. of Colorado*, 421 P.2d 735, 737 (Colo. 1966) (agent who negotiates with authorization from principal is not personally liable if principle is disclosed to third party); *Ace Dev. Co. v. Harrison*, 76 A.2d 566, 570 (Md. 1950) (when an officer as an agent of a company signs a contract on behalf of the corporation, the officer is not personally liable on that contract).

conduct of corporate officers.⁷⁶ Hence, agency law suggests that when officers sign various Exchange Act reports in their capacity as corporate agents, they should not be held personally responsible for inaccuracies within those reports. In this way, the instructions and signature format of the Exchange Act, buttressed by principles of agency, create a strong presumption that the Exchange Act imposes liability on the corporation, rather than officers who sign reports on behalf of the corporation.

C. Liability Imposed Under the New Certification

By requiring personal certification, the Sarbanes Act appears to alter the existing rules. That Act expands officer responsibility to all of the periodic reports, and ties an officer's inaccurate certification to personal, criminal liability.

The new certification makes corporate officials take personal responsibility for their company's financial statements. Underscoring this point, the certification provisions of the Sarbanes Act appear under sections entitled "Corporate Responsibility For Financial Reports."⁷⁷ The Act has two provisions that relate to officer certification, Sections 302 and 906.⁷⁸ Section 302 directs the SEC to enact a new rule requiring officer certification.⁷⁹ Section 906 amends the U.S. Code by enacting a new Section 18 U.S.C. § 1350 that requires officer certification, as well as providing criminal penalties for failing to make such certification.⁸⁰ Both provisions require that a written statement from the CEO and the CFO (or equivalent officers)⁸¹ accompany each periodic report filed with the SEC.⁸² Both

76. See Official Comment to Model Business Corporation Act § 8.42.

77. Pub. L. No. 107-204 §§ 302, 906, 116 Stat. 777, 806.

78. *Id.*

79. See Pub. L. No. 107-204 § 302(a), 116 Stat. 777. The Act requires the SEC's rule to take effect no later than 30 days after the enactment of the Sarbanes Act. See *id.* § 302(c).

80. See Pub. L. No. 107-204 § 906(a), 116 Stat. 806 (amending Chapter 63 of title 18 of the United States Code).

81. Previous proposals called for certification from the chairman of the board as well as these two corporate officers, the CEO and CFO. See H.R. 5118, 107th Cong. § 6 (2002) ("Each periodic report containing financial statements . . . shall be accompanied by a written statement by the chairman of the board chief executive officer, and chief financial officer. . ."). The Corporate Fraud Sarbanes Act of 2002 passed the House on July 16, 2002. *Id.* While the final act did not encompass the chairman of the board, this failure may prove insignificant for many companies. Indeed, most companies tend to combine the office of CEO with that of board chairman, and hence certification from such a board member may have represented significant overlap. While some have proposed separating the two offices, many in the business community, including the Business Roundtable, continue to think that the duality represents a sound business practice. See Business Roundtable, *Principles of Corporate Governance*, (May 2002), available at <http://www.brtable.org/pdf/704.pdf> (last visited Dec. 15, 2002) [hereinafter

provisions also require officers to certify that the financial information contained in the report “fairly present in all material respects the financial condition and results of operations of the issuer.”⁸³ Section 302 goes further, directing the SEC to require the signing officer to state that she has reviewed the report, and that based on her knowledge, the report “does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading.”⁸⁴ These certifications do not replace the existing signature guidelines, but rather serve as an additional statement on the part of corporate officers. As such, they represent an explicit acceptance of such officers’ personal responsibility.

The new certification also extends CEOs and CFOs personal responsibility to all of the periodic reports filed with the SEC.⁸⁵ In this way, the certification makes CEO’s liable for the 10-Q and closes the gap left by the existing signature instructions under the 10-Q.

The Sarbanes Act affirmatively ties violations of the certification requirement to criminal sanctions. Section 906 of the Act has two tiers of liability. A person who “knowingly” violates the certification provision faces a maximum penalty of \$1,000,000, a maximum prison term of ten years, or both.⁸⁶ Willful violations of the provision subject

Principles of Corporate Governance] (“Most American corporations are well served by a structure in which the CEO also serves as chairman of the board”).

82. Pub. L. No. 107-204 §§ 302(a), 906(a), 116 Stat. 777, 806. Section 302 specifically requires certification for each annual and quarterly report, while Section 906 requires an officer certification for each “periodic report containing financial statements filed by an issuer . . . pursuant to section 13(a) . . .” The Sarbanes Act does not define “periodic report.” Given that reports on Form 8-K are filed pursuant to Section 13(a) and some reports on Form 8-K contain financial statements, it is possible to construe Section 906 to include such reports to the extent they include financial statements. In response to this possibility, the SEC quickly adopted a rule stating that for purposes of the Sarbanes Act, Form 8-K is to be considered a current report, and not a periodic report. See SA Release No. 33-8124, Aug. 26, 2002.

83. Pub. L. No. 107-204 §§ 302(a)(3), 906, 116 Stat. 777, 806.

84. Pub. L. No. 107-204 § 302(a)(2), 116 Stat. 777. The certification, which tracks the language of Rule 10b-5 of the Exchange Act, is consistent with the language required under the SEC Order, as well as the language proposed by the SEC. *SEC Order, supra* note 57; *Disclosure Certification*, 67 Fed. Reg. at 41879. The SEC had also proposed that officers certify that every report contains all the information the officer believed to be important to a reasonable investor. See *Disclosure Certification*, 67 Fed. Reg. at 41879.

85. While the SEC proposal and Section 302 of the Act focuses only on adding certification for the 10-K and 10-Q, the SEC Order includes certification of any proxy statements or 8-K filed within the covered period. See *SEC Order, supra* note 57. As noted previously, while it is possible that Section 906 can be read to cover the 8-K, this Article assumes that Section 906 is limited to annual and quarterly reports.

86. See Pub. L. No. 107-204 § 906, 116 Stat. 806 (amending 18 U.S.C. § 1350).

a person to a maximum \$5,000,000 fine, a maximum of twenty years in prison, or both.⁸⁷ This explicit connection with criminal sanctions highlights the fact that officers sign certifications in their personal capacity, and subject to severe personal liability.

Textually, the new certification appears to differ from current signature requirements in at least three ways. First, the new certification makes officers personally liable for the documents they sign. In fact, the certification appears to impose on such officers an affirmative duty to review the financial information contained in their company's disclosure documents. Second, at least for CEOs, the certification extends liability to documents they did not previously have to sign. Third, the certification provision clearly ties any violations to criminal sanctions.

II. FORM OVER SUBSTANCE: EXPOSING THE SIMILARITIES OF LIABILITY BETWEEN THE NEW CERTIFICATION AND EXISTING SIGNATURE REQUIREMENTS

The claim that the new certification dramatically alters an officer's exposure to personal liability rest on the notion that such officer's previous signatures did not carry risk of such exposure, or that the risk was significantly less than the one imposed by the new certification. This Part examines these presumptions. Specifically, this Part explores the extent to which, under current law, a CEO or CFO faces personal liability (a) for signing a disclosure document with knowledge of its falsehood, or (b) for corporate documents that the officer did not sign, but knew contained false information.

A. *Liability of Officers Who Sign Misleading Documents*

1. Primary Liability

Although agency law appears to support the proposition that officers who sign documents on behalf of the corporation bear no responsibility for the contents of such documents, that law also reveals that the format of the actual signatures on some reports exposes signers to personal liability. The clearest way to establish that a given signature reflects liability *only* on behalf of a corporation is to indicate the name of the corporation, followed by the name of

While previous versions of the bill contained only a \$500,00 maximum fine with a five-year prison term, they also expanded liability to those who "recklessly and knowingly" violated the provisions of the Sarbanes Act. See H.R. 3763 § 906(c)(1) (July 15, 2002) (engrossed in Senate).

87. See Pub. L. No. 107-204 § 906, 116 Stat. 806. Previous proposals contained only a \$1 million maximum fine and 10 year prison term. See H.R. 3763 § 906(c)(2) (July 15, 2002) (engrossed in Senate).

the officer and her position.⁸⁸ Placing the corporation's name above the signature line makes it clear that the corporation is taking on the obligations within the document, and that the agent is merely acting on behalf of that corporation. However, when an officer signs a document using his title, while the corporation's name is absent, ambiguity arises.⁸⁹ Such ambiguity makes it possible for courts to hold an individual officer liable for the obligations under that document.⁹⁰ The signature format of the 10-K contains just such an ambiguity. In fact, the 10-K requires two sets of signatures.⁹¹ First, the form contains a signature in which the corporation's name appears above the name and title of the signing officer—the classic form for signatures made on behalf of the corporation.⁹² Then there is another set of signatures that contains only the officer's name and title, with the corporation's name absent.⁹³ As noted, this second set of signatures creates some ambiguity for the directors and officers who sign the 10-K. If only the corporation is to be held liable, why require two different forms of signatures? At the very least, this signature format leaves open the possibility that directors and officers who sign in such a manner can be held personally liable for

88. Indeed, under the Uniform Commercial Code, § 3-402(b)(1), the name of an organization followed by the name and title of an individual is a signature made in a representative capacity.

Thus a signature should be as follows:

ABC, Inc.

By: /s/ Joe Signer

Title: Chief Executive Officer

89. See, e.g., *Homer Nat'l Bank v. Springlake Farms, Inc.*, 616 So. 2d 255 (La. App. 2 Cir. 1993) (allowing parol evidence on issue of whether corporate president's signature, followed by the title president, constituted a personal or corporate guarantee); *Bank of Miami v. Armenteros*, 382 So. 2d 1336 (Fla. Dist. Ct. App. 1980) (finding there was ambiguity when corporate president signed a note with just his title); *St. Joseph Valley Bank v. Napoleon Motors Co.*, 202 N.W. 933 (Mich. 1925) (noting that if corporation's name is omitted from the signature, then signature is deemed ambiguous and it is necessary to provide evidence to determine if the individual signed in her personal capacity).

90. See *Homer*, 616 So. 2d at 255; *Bank of Miami*, 382 So. 2d at 1336; *St. Joseph Valley Bank*, 202 N.W. at 933.

91. See Amendments to Annual Reports Form, 45 Fed. Reg. 63630, 63641 (Sept. 25, 1980).

92. See *id.* The signature line states "the registrant has duly caused this report to be signed on its behalf by the undersigned." *Id.* The format of the signature is as follows:

(Registrant)

By (Signature and Title)

93. See *id.* The signature line states "this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated." *Id.* The format of the signature does not refer to the registrant. Instead, it is as follows:
(Signature and Title)

these reports even under principles of agency.

There is evidence that corporate officials recognize and appreciate the impact of the signature format's ambiguity. In fact, some corporate officials, in an apparent attempt to clarify this ambiguity, have tried to alter the signature lines on the 10-K to include language explicitly stating that signing directors and officers do not intend to execute the document in their personal capacity.⁹⁴ Such an alteration underscores corporate managers' awareness that the current signature requirement includes the risk of individual liability.

This awareness may stem from the SEC's position that the existing signature guidelines subject their signers to personal liability. Indeed, when the SEC changed the signature requirement for the 10-K, its purpose was to enhance the accountability of corporate officers.⁹⁵ Consequently, the SEC consistently has refused to accept filings where corporate officials have sought to limit their personal liability through alteration of the signature lines.⁹⁶ Hence, the SEC has rejected qualifications such as "solely on behalf of the registrant and without personal liability or responsibility."⁹⁷ Instead, the SEC has repeatedly taken the position that by signing the annual report, CEOs and CFOs implicitly indicate their belief that the report is accurate, and such officers can be subject to liability for signing a report without holding such a belief.⁹⁸ This reflects the SEC's understanding that the existing rules do impose personal responsibility on officers and directors who sign reports.

Case law supports this understanding. Most recently, the Ninth Circuit has held that a corporate officer who signs an inaccurate financial statement with knowledge of its inaccuracies can be held personally liable for securities fraud.⁹⁹ In *Howard v. Everex Systems, Inc.*,¹⁰⁰ the plaintiff shareholders claimed that the CEO had violated Section 10(b) and Rule 10b-5 of the Exchange Act by signing a financial statement that contained material misrepresentations.¹⁰¹

94. Thomas Gilroy, *Drafting the Form 10-K*, 1223 PLI-Corp 601, 607-08 (2001).

95. Amendments to Annual Report Form, 45 Fed. Reg. at 63641 (noting that the changed signature will encourage officers to devote needed attention to reviewing the 10-K).

96. See Gilroy, *supra* note 94, at 607-08.

97. See *id.* at 608.

98. See SEC Release No. 34-41987 (Oct. 7, 1999).

99. See *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000). For an in-depth discussion of *Howard* and its implications for directors and officers, see Christian J. Mixer, *Individual Civil Liability Under the Federal Securities Laws for Misstatements in Corporate SEC Filings*, 56 BUS. LAW. 967 (2001).

100. 228 F.3d at 1057.

101. *Id.* at 1060.

Under Section 10(b) and Rule 10b-5, any person can be held liable for making a material misstatement in connection with a securities transaction.¹⁰² However, generally plaintiffs must prove, among other things, that such a person actually made a misstatement or omitted to make a statement when they had a duty to speak.¹⁰³ The plaintiffs

102. Section 10(b) of the Exchange Act, 15 U.S.C. § 78j (1994), provides that:

It shall be unlawful for any person, directly or indirectly

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance of such rules and regulations as the Commission may prescribe.

Id. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2000), states that it:

shall be unlawful for any person, directly or indirectly

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Id.

103. In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Supreme Court held that aiders and abettors could not be subject to liability under Rule 10b-5, instead, only a primary violator “who employs a manipulative device or makes a material misstatement (or omission)” could be held liable for securities fraud under the Rule. *Id.* at 191. Some circuits, when interpreting *Central Bank*, maintain that a primary violator must actually make a material misstatement or omission. *See, e.g., Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir., 1998) (in order to establish liability, the misrepresentation via a statement or omission, must be attributable to the defendant specifically). While other circuit courts impose primary liability on defendants so long as they substantially participated in the preparation of a statement. *See, e.g., In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 (9th Cir. 1994) (substantial participation in fraudulent statements sufficient for primary liability even when that participation does not lead to the defendant actually making a statement). For purposes of this section’s analysis, this Article presumes that the signing officers have not participated in the preparation of the financial statement at issue. Thus, a primary violation under *Central Bank* can only be proved if the defendant actually made an actionable statement or omission. An omission is only actionable if a party has a duty to speak. *See Chiarella v. United States*, 445 U.S. 222, 236 (1980) (holding that a speaker’s silence is only actionable when he has a fiduciary duty to speak).

In addition to proof of a statement or omission, in order to make out a claim under Rule 10b-5, a plaintiff must prove four additional elements. First, that the misstatement is material. *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality as a substantial likelihood that the disclosure or omitted fact would have altered the total mix of information). Second, that the defendant acted with scienter defined as intentional misconduct. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 185 (1976) (finding that in order to violate Rule 10b-5’s requirement of unlawful use of “any manipulative or deceptive device or contrivance” there must be intentional misconduct). Third, under certain circumstances, that the plaintiff relied on the misrepresentation. *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-153 (1972) (requiring proof of reliance in private transactions) *with Basic, Inc. v. Levinson*, 485 U.S. 224, 229-230 (1988) (adopting “fraud on the market” theory, which creates a rebuttable presumption that investors in publicly traded stock rely on material information and misstatements disseminated in the market). Fourth, that the deception occurred in connection with a securities transaction. *See*

in *Howard*, along with the SEC in its amicus curiae brief, argued that the CEO made a statement within the meaning of Rule 10b-5 when he signed the 10-K.¹⁰⁴ The district court disagreed, holding that the executive's signature did not constitute a statement attributable to the signer for purposes of liability.¹⁰⁵ Reversing the district court, the Ninth Circuit supported the plaintiffs' position.

While the Ninth Circuit agreed that merely signing a disclosure document was not enough to establish liability, it found that doing so with the requisite scienter could establish liability. Indeed, several courts previously had held that merely signing a false financial statement could not subject the signer to liability under the Exchange Act.¹⁰⁶ However, the Ninth Circuit distinguished between such cases, and those where the plaintiff proved that the defendant acted with scienter—defined as acting with knowledge of falsity or with an intent to defraud.¹⁰⁷ The appeals court found that these latter cases can impose personal liability on the signing officers, irrespective of the fact that the officers signed “on behalf” of the corporation, and did not participate in preparing the financial statements at issue.¹⁰⁸ According to the court, “when a corporate officer signs a document on behalf of the corporation, that signature will be rendered meaningless unless the officer believes that the statements in the document are true.”¹⁰⁹ Because the district court made a blanket decision enabling defendants to escape liability regardless of their belief in a report's accuracy, its decision was

Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 13 (1971). To recover damages, the plaintiff must also prove that the defendant's conduct caused the plaintiff's loss. See Exchange Act, § 21D(b)(4), 15 U.S.C. 78u-3 (requiring plaintiffs to prove loss causation).

104. See *Howard*, 228 F.3d at 1061.

105. See *Howard v. Hui*, 1998 WL 795186 (N.D. Cal) (granting judgment as a matter of law in favor of CEO).

106. See, e.g., *In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d 214, 235 (D.N.J. 2002) (allegations that an officer signed a filed document, standing alone, are not enough to impose liability); *In re Browning-Ferris, Indus. Inc. Sec. Litig.*, 876 F. Supp. 870, 911 (S.D. Tex. 1995) (mere signing of document not sufficient to establish liability); *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239, 1256 (W.D. Mich. 1991) (dismissing a C.O.O. from a claim because he played no role in the fraud, apart from signing the 10-K).

107. See, e.g., *Hochfelder*, 425 U.S. at 194 n.12 (defining scienter as a mental state embracing intent to deceive, manipulate or defraud); *City of Philadelphia v. Fleming Co., Inc.*, 264 F.3d 1245, 1261 (10th Cir. 2001) (scienter requires that defendant knew of misleading fact); *In re Paradyne Networks, Inc. Sec. Litig.*, 197 F. Supp 2d 1349, 1355 (M.D. Fla. 2002) (finding that scienter requires knowledge that documents are false and misleading); *Precision Vascular Systems, Inc. v. Sarcos, L.C.*, 199 F. Supp. 2d 1181 (D. Utah 2002) (scienter proven with knowledge of misleading facts).

108. *Howard*, 228 F.3d at 1061.

109. *Id.* at 1061.

incorrect.¹¹⁰ The Ninth Circuit reasoned that the district court's position would significantly weaken the securities laws by allowing corporate officers to shield themselves from liability even when they knowingly sign off on false financial statements.¹¹¹

Other cases support the Ninth Circuit's position that corporate officers can be held liable for signing inaccurate Exchange Act reports with knowledge of the inaccuracy. *Howard* is distinct because it is one of the few cases addressing the merits of a securities fraud claim.¹¹² Most other securities claims arise in the context of pleading issues.¹¹³ Yet numerous courts in such context have stated that plaintiffs who prove that corporate officers have signed disclosure documents with knowledge of the misstatement contained therein, make out a viable claim for securities fraud.¹¹⁴ These cases confirm

110. See *id.* at 1063.

111. See *id.* at 1062 ("Key corporate officers should not be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements.").

112. See *Mixter*, *supra* note 99, at 967.

113. See *id.*

114. See, e.g., *Blake v. Diederff*, 856 F.2d 1365, 1369 (9th Cir. 1988) (defendant makes a statement when he signs documents known to be false); *In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d at 228 (suggesting that a CEO who signed a 10-Q faced liability); *In re JDN Realty Corp. Sec. Litig.*, 182 F. Supp. 2d 1230, 1242-43 (N.D. Ga. 2002) (allegations that corporate officers who signed public documents in the name of the corporation, knowing they contained materially false and misleading information, sufficiently alleged claim under Section 10 of the Exchange Act); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1081 (N.D. Cal. 2001) (financial statements signed by CFO can be attributed to him for purpose of 10(b) action); *SEC v. Enterprises Solutions, Inc.*, 142 F. Supp. 2d 561, 575 (S.D.N.Y. 2001) (CEO can be personally liable under Rule 10b-5 for signing a document on behalf of the corporation when he knew the document to be misleading); *In re Reliance Sec. Litig.*, 135 F. Supp. 2d 480, 502 (D. Del. 2001) (corporate directors made statements within the meaning of Section 10 and Rule 10b-5 by signing disclosure documents that they had the opportunity to review); *Sheehan v. Little Switzerland*, 136 F. Supp. 2d 301, 313-14 (D. Del. 2001) (both CEO who signed 8-K, and CFO who signed 10-Q, with knowledge of misstatements acted with sufficient scienter to be held personally liable); *In re Independent Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 767 (S.D.N.Y. 2001) (if director acted with the requisite scienter, by affixing his name to prospectus, he adopted statements and can be held liable for misrepresentations); *In re American Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 443 (S.D.N.Y. 2000) (CEO and CFO who signed the 10-K and 10-Q, and knew of misstatements within such reports could be held liable for them); *In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 142 (S.D.N.Y. 1999) (CEO and CFO could be held personally liable who signed documents when they were aware of facts that undermined the accuracy of the information contained in the documents); *SEC v. Chester Holdings, LTD.*, 41 F. Supp. 2d 505, 524 (D.N.J. 1999) (both CEO and president who signed numerous periodic reports acted with scienter because they lacked a genuine belief in the accuracy of the information and thus could be held personally liable); *In re Value Jet, Inc. Sec. Litig.*, 984 F. Supp. 1472, 1478 (N.D. Ga. 1997) (liability can be imposed on defendant who signed a 10-K containing

the SEC's view that by signing a document with knowledge of its falsehood, executives expose themselves to personal liability.

2. Secondary Liability

Existing law reveals that officers who sign periodic reports containing fraudulent information also risk secondary liability as control persons. Under Section 20(a) of the Exchange Act, every person who directly or indirectly controls an entity or natural person liable under any provision, rule or regulation of the Exchange Act is jointly and severally liable to the same extent as the controlled person, unless she can establish a valid defense.¹¹⁵ In order to establish a prima facie case of control person liability, a plaintiff must prove a primary violation of the Act, and that the defendant controlled the primary violator.¹¹⁶ After such proof, a control person

facts defendant knew to be misleading); *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1255-56 (S.D.N.Y. 1996) (defendants personally liable for misstatements in 10-K they signed).

115. Section 20(a) provides that:

[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . .

15 U.S.C. § 78t(a) (1994). The Securities Act of 1933, as amended (the "Securities Act"), has a similar control person provision. Section 15 of the Securities Act provides that:

[e]very person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [section 11 or 12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . .

15 U.S.C. § 77o (1994). Section 11 relates to liability for false registration statements, 15 U.S.C. § 77k (1994), while Section 12 creates liability in connection with prospectuses and other communications. 15 U.S.C. § 77(l) (1994). Hence, Section 15 liability has a narrower focus than Section 20(a) of the Exchange Act, which encompasses all provisions of that Act. *See, e.g.,* Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 4 (1997) (noting that secondary liability under section 20(a) is greater than section 15 because sections 11 and 12 are carefully delineated provisions with carefully constructed defenses). As a result, Section 20(a) is more widely litigated than Section 15. *See id.* at 6. Despite this fact, the two sections appear to define control in the same manner. *See id.* at 4. *See also* Pharo v. Smith, 621 F.2d 656, 673 (5th Cir. 1980) (noting that Section 20(a) is an analogue of Section 15 and thus the sections have the same interpretation); *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 407 (S.D.N.Y. 2001) (noting that the standard to determine control person liability under the Exchange Act also applies to determine control person liability under the Securities Act).

116. *See, e.g.,* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991).

can escape liability only if she “acted in good faith, and did not directly induce the act or acts constituting the violation or cause of action.”¹¹⁷ Hence, once a plaintiff establishes that a corporation filed a periodic report in violation of the Exchange Act, the critical issues become whether the officers who signed the report qualify as control persons, and if so, whether they can assert a viable defense.

Although determining control person status represents a threshold issue, making such a determination is not straightforward. In fact, the Exchange Act does not define control.¹¹⁸ Legislative history reveals that this lack is deliberate.¹¹⁹ Congress reasoned that the broad range of situations in which control may be exerted counseled against setting out a specific definition of control persons for purposes of the Exchange Act.¹²⁰ Unfortunately, Congress’ failure to provide definitional clarity in this area has led to considerable conflict among the circuits. Review of the cases reveals that definitions of control fall along two general axes. A majority of courts have adopted a broad definition of control that focuses on the

117. 15 U.S.C. § 78t(a) (1994). See *Hollinger*, 914 F.2d at 1575. Under Section 15 of the Securities Act, a defendant escapes liability only if she had “no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.” 15 U.S.C. § 77o (1994). Courts differ as to whether defendants must affirmatively establish their good faith or lack of knowledge, or if plaintiffs must establish culpable participation on the part of the defendant which includes some degree of bad faith or knowledge. See Lowenfels & Bromberg, *supra* note 114, at 6-7 (noting that courts adopting the culpable participation tests appear to shift the burden of proof from the defendant to the plaintiff).

118. In contrast, Section 15 of the Securities Act suggests that control may be established through stock ownership, agency or otherwise. 15 U.S.C. § 77o (1994). Also, under Rule 405 of the Securities Act of 1933, the SEC defines control as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 230.405 (2002).

119. H.R. REP. NO. 73-1383 at 26 (1934) (noting that it was “undesirable” to attempt to define the term control). See also *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 (3rd Cir. 1975) (noting that Congress deliberately left open the definition of control in order to allow courts to construe the statute along with the evidence at trial); Laura Greco, Note, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 171-72 (1999) (noting that legislative history makes clear that Congress “intentionally omitted fixed criteria” for defining a control person); Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 274 (1997); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward An Improved Analysis*, 126 U. PA. L. REV. 1345, 1347-48 (1978) [hereinafter *Secondary Liability*] (noting that Congress intended to allow broad and flexible application of the provision).

120. H.R. REP. NO. 73-1383 at 26 (1934) (noting that would be “difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted”). Congress did note that the term control was designed to include both actual and legally enforceable control. *Id.*

defendant's power or potential influence over the entity that committed the fraud.¹²¹ Other courts employ more narrow criteria, focusing on the defendant's culpability in the fraudulent conduct at issue.¹²²

a. Control Based on Potential Influence

In defining control, the majority of circuits focus on a defendant's power or potential power over the primary violator.¹²³ The most widely used test for determining control under this standard is the Eighth Circuit's two-part inquiry.¹²⁴ The inquiry requires a plaintiff to show that the defendant "actually participated in (i.e., exercised control over) the operations of the corporation in general," and "possessed the power to control the specific transaction or activity upon which the primary violation is predicated."¹²⁵ Other courts simply focus on whether a defendant had the power to influence corporate policy or general corporate affairs, seemingly irrespective of her ability to impact the specific transaction at issue.¹²⁶ Under either approach, courts take the position that a defendant's potential

121. See, e.g., *Howard*, 228 F.3d at 1065; *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993); *Harrison v. Dean Witter Reynolds, Inc.* 974 F.2d 873, 881 (7th Cir. 1992); *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 896-98 (10th Cir. 1992), *rev'd in part on other grounds*, 511 U.S. 164 (1994); *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990).

122. See *infra* note 163.

123. See *Lowenfels & Bromberg*, *supra* note 115, at 10-11 (noting that all but four circuits—the Second, Third, Fourth and Ninth—adopt a potential control or influence test to determine control).

124. *Id.* ("the most widely used test for determining whether a defendant is liable as a controlling person under section 15 and section 20(a) is the . . . two-prong test"). See *Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609, 873 (7th Cir. 1996) (adopting similar two-part test); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 486 (6th Cir. 1992) (citing *Metge* with approval). While the Eleventh Circuit has adopted a similar two-part test, the first prong of its test does not require the plaintiff to prove actual control over the general affairs of the entity. See, e.g., *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396 n.6 (11th Cir. 1996). Under that test, a plaintiff must show that the defendant "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws," and "had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability." *Id.* at 396 (quoting *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)).

125. *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (quoting *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984)).

126. The Fifth Circuit appears to have adopted this approach. See, e.g., *Abbott*, 2 F.3d at 620 (focusing on power to control general affairs); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981) (focusing on power to influence corporate policy). In *Thompson*, the Fifth Circuit rejected the defendant's argument that he needed to participate in the transaction giving rise to the violation, and instead maintained that a person who has the requisite power to influence corporate policy may be considered a control person. See *id.*

to influence the conduct at issue subjects her to control person liability.

Applying this standard, some courts have found that the potential control inherent in the position of a top official, such as a corporate CEO or CFO, qualifies such an official as a control person. Such courts do not require plaintiffs to prove that a defendant actually exercised authority over the violator.¹²⁷ Instead, courts determine who controls a given entity by looking at the position an individual holds within that entity, reasoning that an individual who occupies a position that ordinarily conveys authority over corporate affairs has control for purposes of the Exchange Act.¹²⁸ Both the CEO and the CFO fit neatly into this definition of control. As the highest level office within a corporation, the position of CEO inherently carries considerable power. Indeed, most statutes confer upon the CEO the duty to control the company's management and policies.¹²⁹ The Business Roundtable, an association of leading CEOs,¹³⁰ maintains that the CEO is responsible for running the day-to-day operations of the company, including operations related to financial reporting.¹³¹ Similarly, a CFO's position suggests a potential to influence corporate financial affairs. CFOs generally are responsible for overseeing the financial affairs of the corporation, and by extension, disclosure documents containing financial information.¹³²

Recognizing the inherent authority within both of these positions, courts have found that such positions warrant treating officers who hold them as control persons. In *In re Cylink Securities Litigation*,¹³³ shareholders sought to hold a CEO and a CFO liable as

127. See, e.g., *Stern v. Amer. Bankshares Corp.*, 429 F. Supp. 818 (D. Wis. 1977) (noting that one can be a controlling person without having exercised control); *Harriman v. E.I. DuPont De Nemours & Co.*, 372 F. Supp. 101 (D. Del. 1974) (essential factor in determining whether control exists is the power or potential power of control, as opposed to the actual exercise thereof).

128. See e.g., *Amer. Gen. Ins. Co v. Equitable Gen. Corp.*, 493 F. Supp. 721 (E.D. Va. 1980) (directors prima facie controlling person because of their ability to exert influence over decision-making process); *Metzger v. American Food Mgmt., Inc.*, 389 F. Supp. 469 (W.D. Pa. 1975) (officers and directors of a company definitely in a position of control because under state law they have positive duty to manage affairs of the corporation).

129. See, e.g., *Minn. Prac., Corporation Law & Practice* § 4.4 (defining chief executive officer's duty to actively management the corporation's business); See also *Metzger*, 389 F. Supp. at 471 (noting power conferred on officers under state law).

130. According to its report, the Business Roundtable is an association of CEO's from corporations that employ a workforce of over 10 million people, and account for \$3.5 trillion in revenues. *Principles of Corporate Governance*, supra note 80, at iii.

131. See *id.* at 6.

132. See, e.g., *Minn. Prac., Corporation Law & Practice* § 4.4 (defining role of chief financial officer as keeping accurate financial records of the corporation).

133. 178 F. Supp. 2d 1077 (N.D. Ca. 2001).

control persons based on allegations that the company for which they worked filed fraudulent financial statements in violation of the Exchange Act.¹³⁴ The plaintiffs claimed that the company fraudulently overstated revenue reported on its 10-Q.¹³⁵ Seeking to hold the executive officers liable as control persons, the plaintiffs alleged that such officers, by virtue of their executive positions, had the power to control and influence the corporation.¹³⁶ The court found such allegations sufficient to support an inference that the CEO and CFO controlled the company and its operations for purpose of derivative liability.¹³⁷

A similar claim was made against a defendant who served as CEO of a company alleged to have filed periodic reports that misrepresented the company's financial condition.¹³⁸ Plaintiffs contended that through his position, the CEO had the authority to control the general affairs of the company as well as the content of any disclosure documents disseminated to the public.¹³⁹ Like *In re Cylink*, the court found such allegations sufficient to state a cause of action for control person liability.¹⁴⁰ Along these lines, several other courts have found that plaintiffs could establish a *prima facie* case of control person liability based on the fact that a defendant served as a CEO, CFO or other high-level officer within the company found to have violated the Exchange Act.¹⁴¹ Such courts reasoned that these

134. *Id.* at 1079

135. *Id.* The plaintiffs claimed that the company prematurely recorded revenue for major transactions in violation of GAAP's revenue recognition principles, and that such premature recognition was done deliberately to enhance the company's financial performance. *Id.* at 1080-81.

136. *Id.* at 1089.

137. *Id.* (noting that plaintiffs need not allege that the "defendants actually participated in the wrongful conduct or actually exercised power").

138. *See In re JDN Realty Corp. Sec. Litig.*, 182 F. Supp. 2d 1230 (N.D. Ga. 2002). The company was forced to restate its financial statements, which led to a material reduction in its net income. *Id.* at 1238.

139. *Id.* at 1246.

140. *Id.*

141. *See, e.g., In re Hamilton Bankcorp., Inc. Sec. Litig.*, 194 F. Supp. 2d 1353, 1360 (S.D. Fla. 2002) (noting that defendants' positions in management gave them the potential to control the company's affairs, including the content of their public financial statements, and hence subjected them to control person liability); *In re Miller Industries, Inc. Sec. Litig.*, 12 F. Supp. 2d 1323, 1333 (N.D. Ga. 1998) (defendants' positions as officers and directors in a company enabled them to control the affairs of the company as well as the dissemination of the inaccurate public documents); *In re ValuJet, Inc. Sec. Litig.*, 984 F. Supp. 1472, 1480 (N.D. Ga. 1997) (noting that controlling person liability asserted with allegation that defendants' management positions enabled them to control the company's general affairs); *Schaffer v. Timberland Co.*, 924 F. Supp. 1298, 1322 (D.N.H. 1996) (allegations that one of the defendants held the position as chairman of the board and chief executive officer were sufficient to survive a motion for summary judgment regarding his control person

officers' positions reflected their potential to influence both the company and the financial documents that the company filed.¹⁴² Based on these cases, the mere fact that a person holds the office of CEO or CFO can subject her to control person liability.

Other courts reject reliance solely on status. These courts maintain that a person's status as an officer or director of a corporation does not automatically qualify her as a control person.¹⁴³ Courts reason that focusing only on status fails to capture the crux of control person liability, which intends to penalize those persons who actually exercised influence over the primary violator.¹⁴⁴ Indeed, many executive officers delegate their authority. Hence despite their status, such officers may not have any actual control over the fraudulent transaction at issue. This fact counsels against applying a control by status approach and holding a CEO or CFO liable simply because of their positions.

However, courts often maintain that a person's status, coupled with signing responsibility for a fraudulent document, sufficiently establishes control for purposes of Section 20(a).¹⁴⁵ As one court noted, "[i]t does comport with common sense to presume that a person who signs his name to a report has some measure of control over those who write the report."¹⁴⁶ Thus, courts have enabled plaintiffs to plead control person status against numerous directors and executive officers through claims that such defendants held positions allowing them to influence the conduct of a given company, and that such defendants signed false and misleading periodic reports.¹⁴⁷ These courts reason that a person's signature on a

status).

142. See *supra* note 141.

143. See, e.g., *Dennis v. General Imaging, Inc.*, 918 F.2d 496 (5th Cir. 1990); *In re Independent Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 772 (S.D.N.Y. 2001) ("It is well established that officer or director status alone does not constitute control."); *In re Livent, Inc. Sec. Litig.*, 78 F. Supp. 2d 194, 221 (S.D.N.Y. 1999).

144. See *In re Leslie Fay Companies, Inc. Sec. Litig.*, 918 F. Supp. 749, 764 (S.D.N.Y. 1996) (noting that courts must look at all indicia of control).

145. See, e.g., *In re Independent Energy Holdings PLC*, 154 F. Supp. 2d at 772 (noting that when control is measured only by a defendant's potential to influence an entity, the defendant's status alone does not confer control, but allegations that the defendant signed fraudulent documents can establish control).

146. *Jacobs v. Coopers & Lybrand, L.L.P.*, 1999 WL 101772 at *18 (S.D.N.Y. Mar. 1, 1999).

147. See *Howard*, 228 F.3d at 1066 (CEO); *Jacobs*, 1999 WL 101772 at *18 (allegations that outside director signed fraudulent report and was in a position to exercise control enough to withstand motion to dismiss); *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 207 (E.D.N.Y. 1997) (allegations that a president and a director signed fraudulent 10-K and 10-Q sufficient to plead a violation of Section 20(a)); *In re Leslie Fay Companies, Inc.*, 918 F. Supp. at 763 (allegations that various directors and officers, including the controller and CEO, signed at least one of the

document supports an inference that she has some control over a company's operations as well as the company's representations disseminated to the public.¹⁴⁸ Indeed, signing officers who serve as executives satisfy the Eighth Circuit's two-part test that requires plaintiffs to show that defendants 1) actually participated in the corporation's operations and 2) had power to control the actions upon which the securities fraud violation were based.¹⁴⁹ First, an executive officer's position suggests that she has general control over the corporation's affairs, while the fact that she's responsible for signing certain reports suggests that she actually participated in those affairs. Second, because such an officer signs fraudulent reports, she has the potential to influence the transaction upon which the primary violation is predicated. In other words, because the Exchange Act requires her signature in order for the company to file the report, the officer has the power to approve a company's financial statement. Such power means that these officers can prevent a report's issuance or make corrections to the content of the reports. This analysis supports decisions that impose control person liability on executives who sign a company's disclosure documents.

Other courts have held that plaintiffs make out a claim of control person liability when they allege that an officer holds a high level position, and knows that the company's financial condition differs from that reported in its public documents.¹⁵⁰ Armed with their knowledge, these officers' positions provide them with the authority to correct or cause corrections to a periodic report.¹⁵¹ Courts then justify imposing control person status on such officers because they could have prevented fraudulent disclosure and the shareholder losses resulting from such disclosure. In this vein, plaintiffs in *In re Xerox Corp. Securities Litigation* alleged that the CEOs and CFO of Xerox were control persons by virtue of their high level positions and their intimate knowledge of the company's financial condition; a condition that contradicted information contained in the company's

fraudulent reports sufficient for control person liability under Section 20(a)).

148. See, e.g., *In re Leslie Fay Companies, Inc.*, 918 F. Supp. at 763. However, courts have explained that when a defendant has not served as an officer throughout the entire course of the fraud, his signature does not raise an inference of control because "it is not logical to presume that, as a signatory of the form, [the defendant] was a person able to exert control over those who wrote the material misstatements the form contained." *Jacobs*, 1999 WL 101772 at *18. Hence, such a defendant cannot be held liable as a control person. See *id.*

149. See *Metge*, 762 F.2d at 631.

150. See, e.g., *In re Xerox*, 165 F. Supp. 2d at 220; *In re Fine Host Corp. Sec. Litig.*, 25 F. Supp. 2d 61, 73 (D. Conn. 1998).

151. See *Salkind v. Wang*, 1995 WL 170122, at *1 (D. Mass. 1995) (noting officers who have knowledge of discrepancies have the power to cause corrective disclosures).

periodic report.¹⁵² Plaintiffs maintained that each of the officers had detailed knowledge of the financial problems plaguing Xerox, and were given copies of various quarterly and annual financial reports that failed to address those problems.¹⁵³ According to the plaintiffs, by virtue of their knowledge and position, such officers had the ability and the opportunity to prevent the issuance of such reports or cause them to be corrected.¹⁵⁴ These allegations qualified them as control persons under Section 20(a).¹⁵⁵ The district court agreed, finding that such allegations went beyond mere status and were “plainly” sufficient to survive a motion to dismiss.¹⁵⁶

Moreover, if an officer has knowledge of misstatements within disclosure documents, then the officer does not have a valid defense to avoid control person liability. Because the statute provides an affirmative defense, alleging control person status does not end the Section 20(a) inquiry.¹⁵⁷ Hence, while such allegations may be sufficient to avoid a motion for summary judgment or a motion to dismiss, at trial defendants have the opportunity to prove that they acted in good faith and did not induce the fraudulent activity at issue.¹⁵⁸ Such proof enables them to avoid being held liable as a control person. As one court explained, knowledge is key to an assertion of the affirmative defense under Section 20(a).¹⁵⁹ Indeed, when a plaintiff cannot prove that a defendant knew or should have known of the facts giving rise to the violation, courts will refuse to impose control person liability.¹⁶⁰ By contrast, a defendant’s knowledge negates good faith. Thus, officers who sign periodic reports knowing that they contain inaccurate information cannot satisfy their burden of proving good faith.¹⁶¹ For that reason, several

152. *In re Xerox*, 165 F. Supp. 2d at 220.

153. *Id.* at 218-220.

154. *Id.*

155. *Id.*

156. *Id.* (citing *In re Fine Host Corp.*, 25 F. Supp. 2d at 73).

157. *See* 15 U.S.C. § 78t(a).

158. *See, e.g., In re Cylink*, 178 F. Supp. 2d at 1089 (noting that defendant will be given the opportunity to assert good faith at a later stage in the proceedings); *Jacobs*, 1999 WL 101772 at *18 (good faith and lack of participation can be argued by defendant at a later stage)

159. *See Ingenito v. Bermec Corp.*, 441 F. Supp 525 (S.D.N.Y. 1977)

160. *See, e.g., Lanza v. Drexel & Co.*, 479 F.2d 1277(2nd Cir. 1973) (holding that director could not be held liable as a control person since he had no knowledge that the information disseminated to the public was false or misleading); *Mader v. Armel*, 461 F.2d 1123 (6th Cir. 1972) (conclusion that defendant not a controlling person justified because no evidence that defendant knew or should have known of wrongdoing); *Hamilton Bank & Trust Co. v. Holliday*, 469 F. Supp. 1229 (N.D. Ga. 1979) (directors exempt from liability as controlling person because had no knowledge of misrepresentations).

161. The Securities Act explicitly makes this point in its parallel control person

courts have expressed a willingness to hold CEOs or CFOs liable as control persons for signing documents when they know the information within them is misleading.¹⁶²

b. Control Based on Culpable Participation

Some circuits require that in addition to establishing control, a plaintiff also prove that the defendant was a culpable participant in the fraudulent activity in order to establish a prima facie case of control person liability.¹⁶³ Courts maintain that this standard ensures that not all officers automatically face control person liability.¹⁶⁴ The Third Circuit, the strongest proponent of the culpable participation approach,¹⁶⁵ noted that Congress did not intend officers to act as insurers for the misdeeds of the corporations, and that the culpable participation standard allows courts to avoid this kind of strict

provision. *See* Securities Act § 15, 15 U.S.C. § 77o (1994). Indeed, under the Securities Act, a control person escapes liability only if they “had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.” 15 U.S.C. § 77o (1994). *See also Howard*, 228 F.3d at 1066 (a defendant who cannot show lack of scienter cannot show that he acted in good faith).

162. *See, e.g., Sheehan*, 136 F. Supp. at 315 (CEO who signs an SEC filing knowing that it contains misleading omissions demonstrates culpability as a control person); *Enterprises Solutions, Inc.*, 142 F. Supp. 2d at 561 (CEO who signs a registration statement with knowledge of its inaccuracy is liable as a control person); *In re Oxford Health Plans*, 187 F.R.D. at 143 (CEO and CFO who signed documents with awareness of facts that made documents misleading could be subject to control person liability); *Robbins v. Moore Medical Corp.*, 788 F. Supp. 179, 189 (S.D.N.Y. 1992) (defendant who signed statement when knew of deceptive acts or facts that contradicted statement could be held liable as a control person).

163. The Second Circuit was the first to require culpable participation. *See Lanza*, 479 F.2d at 1299 (noting that Congress intended to impose liability only on those persons who in some meaningful sense are culpable participants in the fraud). Later, the Third, Fourth and Ninth Circuit would adopt the culpable participation doctrine. *See, e.g., Kersh v. General Council of the Assemblies of God*, 804 F.2d 546, 549 (9th Cir. 1986) (noting that control person liability required a showing that the defendant was a culpable participant in the alleged activity); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981); *Carpenter v. Harris, Uphman & Co.*, 594 F.2d 388, 394-95 (4th Cir. 1979); *Rochez Brothers, Inc. v. Rhoades*, 527 F.3d 880, 885 (3rd Cir. 1975) (citing *Lanza* with approval).

164. *See Rochez Bros.*, 527 F.3d at 885. However, courts that have rejected the culpable participation argument note that requiring plaintiffs to prove more than control status would erroneously import the good faith defense into the prima facie case. *See, e.g., Food and Allied Serv. Trades Dept. v. Millfeld Trading Co., Inc.*, 841 F. Supp. 1386, 1390 (S.D.N.Y. 1994); *Borden, Inc. v. Spoor Behrins Campbell & Young, Inc.*, 735 F. Supp. 587, 590 (S.D.N.Y. 1990); *Terra Res. I v. Burgin*, 664 F. Supp. 82, 88 (S.D.N.Y. 1987).

165. *See Mixter, supra* note 99, at 974 n.36 (“The Third Circuit has been the most consistent exponent of the minority view”); *Lowenfels & Bromberg, supra* note 115, at 21-24 (noting strength of the culpable participation test in the Third Circuit).

liability.¹⁶⁶

Unlike the potential control test, courts applying the culpable participation standard do not allow a plaintiff to establish control person liability based on allegations that a defendant held a high level position and signed a document containing misleading information. Thus, the court in *In re Independent Energy Holdings PLC Securities Litigation*¹⁶⁷ noted that under a potential control approach control person liability could be proved based on allegations that the defendant signed or had access to public documents while serving in a high level position.¹⁶⁸ However, the court pointed out that such allegations failed to state a claim for control person liability under the culpable participation standard because one cannot infer a defendant's culpability solely from his signature on a misleading report.¹⁶⁹ This outcome distinguishes the culpable participation test from the potential control test, and suggests that some officers may avoid control person liability when courts apply the former approach.

However, the culpable participation standard represents the minority view. In fact, only the Second, Third, Fourth, and Ninth Circuits have endorsed at some point the culpable participation approach.¹⁷⁰ Of these circuits, the Third Circuit has most consistently adhered to the standard.¹⁷¹ In comparison, the Second Circuit initially endorsed the standard,¹⁷² backed away from it,¹⁷³ and then appeared

166. See *Rochez Brothers*, 527 F.2d at 885 (citing legislative history of Section 20(a) and noting that Congress ultimately rejected an insurers plan under which directors and officers would be held strictly liable for corporate actions).

167. 154 F. Supp. 2d 741 (S.D.N.Y. 2001).

168. *Id.* at 772. In that case, the plaintiff brought a control person claim under both Section 15 of the Securities Act and Section 20(a) of the Exchange Act. *Id.* at 669. The court concluded that Section 20(a) required a showing of culpable participation. *Id.* at 770. However, the court explained that in order to plead control person liability under the Securities Act, a plaintiff need only allege a defendant's control over the primary violator. *Id.* at 770. Analyzed under the potential control test, the court found that pleading a person's status and that he is a signatory sufficiently establishes control for purposes of Section 15 liability. *Id.*

169. *Id.* at 772-73. The court noted that such allegations do not automatically lead to an inference that the defendant acted with the necessary state of mind. *Id.*

170. See, e.g., *Mixter*, *supra* note 99, at 974 n.36 (defining potential control test as majority approach and citing cases); *Lowenfels and Bromberg*, *supra* note 115, at 10-11 (noting that potential control test represents majority view). Some explain that the Sixth Circuit's position as unclear. See *Mixter*, *supra* note 99, at n.3. Indeed, some district courts confirm this lack of clarity. See *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1134 (W.D. Mich. 1996) (noting that the Sixth Circuit had not defined a control test); *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010 (N.D. Ohio 2000) (citing both control tests). However, Sixth Circuit opinions appear to approve the potential for a control test. See, e.g., *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.* 973 F.2d 474, 486 (6th Cir. 1992).

171. See *supra* note 165.

172. See, e.g., *Lanza*, 479 F.2d at 1299 (adopting culpable participation test).

to reaffirm its acceptance of the culpable participation standard.¹⁷⁴ As a consequence, courts in that circuit have not consistently applied the culpable participation approach.¹⁷⁵ Moreover, other circuits have moved away from the culpable participation approach. The Ninth Circuit appears to have rejected such a view definitively.¹⁷⁶ The Fourth Circuit also appears to have rejected the culpable participation standard.¹⁷⁷ This suggests that the standard only has acceptance in the Second and Third Circuit. The standards rejection in other circuits also decreases the likelihood that an executive officer will be able to avoid control person liability through application of the culpable participation standard.

More importantly, courts have indicated that plaintiffs satisfy the culpable participation test by alleging that an executive officer

173. See, e.g., *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980) (neither scienter nor culpable participation required to allege a case of control person status).

174. See, e.g., *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (plaintiff must establish that defendant's culpable participation in conduct at issue).

175. See, e.g., *In re Health Mgmt., Inc.*, 970 F. Supp. at 206 (describing split in Second Circuit and noting that the most recent statement by the Second Circuit holds that a prima facie case of control person status only requires pleading control status, not culpable participation); *Food & Allied Serv. Trades Dep't*, 841 F. Supp. at 1390 (describing cases reflecting that "courts within the Second Circuit have not ruled consistently as to whether scienter or culpable participation must be pleaded" in order to establish control person liability). In 1997, Lowenfels and Bromberg concluded that the Second Circuit was backing away from the culpable participation requirement. See Lowenfels & Bromberg, *supra* note 115, at 25. However, recently many district courts in the Second Circuit have applied the culpable participation doctrine. See *Cyber Media Group, Inc. v. Island Mortgage Network, Inc.*, 183 F. Supp. 2d 559, 575-77 (E.D.N.Y. 2002); *Lowe v. Salomon Smith Barney, Inc.* 206 F. Supp. 2d 442, 447-48 (W.D.N.Y. 2002); *Roer v. Oxbridge Inc.*, 198 F. Supp. 2d 212, 230-31 (E.D.N.Y. 2001); *In re Indep. Energy Holdings PLC*, 154 F. Supp. 2d at 769-70 (in order to prove a prima facie case of control person liability, a plaintiff must allege "(1) an underlying primary violation of the securities laws by the controlled person; (2) control over the controlled person; and (3) that the controlling person was in some meaningful sense a culpable participant in the controlled person's primary violation").

176. Compare *Wool*, 818 F.2d at 1440 (to state a claim of control person liability, a plaintiff must prove that the defendants were culpable participants in the alleged illegal activity) with *Howard*, 228 F.3d at 1065 n.10 (noting that *Wool* had been overruled "to the extent [it] required a showing of culpable participation to make out a prima facie case" on control person liability) and *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1161 (9th Cir. 1996) (plaintiffs need not allege culpable participation) and *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990) (culpable participation not required). See also Greco, *supra* note 119, at 184 (noting that the Ninth Circuit has moved away from strict adherence to the culpable participation test); Neil Bregenzer, Comment, *Controlling Person Liability Under the Federal Securities Laws in the Ninth Circuit: Toward a Reconsideration of the Culpable Participation Doctrine*, 69 OR. L. REV. 337, 377 (1990) (noting that the culpable participation test may be on the wane among Ninth circuit district courts).

177. See *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990).

signed a report and knew that it contained information inconsistent with the company's financial affairs. Thus, in *In re Reliance Securities Litigation*, plaintiffs alleged that several officers and directors, including the CFO, were liable as control persons for signing various periodic reports containing misleading financial information.¹⁷⁸ The defendants moved for summary judgment arguing that the plaintiffs had not established that they controlled the violator, and that there was no evidence to prove that the defendants had participated in the fraud.¹⁷⁹ The court disagreed with both assessments. The court pointed out that each of the defendants served in positions that related to overseeing the company's accounting and reporting practices, and hence could be viewed as exercising control over the company.¹⁸⁰ The court began by confirming that a plaintiff must show more than control to satisfy the culpable participation standard.¹⁸¹ Rather a "plaintiff must show that the defendant participated in the fraud or furthered the fraud through [deliberate] inaction."¹⁸² Applying this standard, the court agreed that there was no evidence showing that the defendants intentionally perpetrated a fraud.¹⁸³ Despite this lack, the court explained that a reasonable juror could conclude that the defendants culpably participated in the fraud by signing, and hence approving, misleading documents while knowing that such documents were not accurate.¹⁸⁴ Apparently the court believed that the defendants' familiarity with the company's financial affairs, along with their signing responsibilities, may have put them in a position to prevent the fraud, and could render them culpable participants when they failed to do so.¹⁸⁵ Under this approach, other courts appear to agree that an executive officer who signs a report knowing it to be fraudulent can be viewed as a control person even under the culpable

178. See *In re Reliance Securities Regulation*, 135 F. Supp. 2d at 490-91. Plaintiffs contended, among other things, that the financial information in the Form 10-K signed by all of the defendants materially overstated the company's income. *Id.* at 491.

179. *Id.* at 519.

180. *Id.* at 518 (concluding that such oversight raised genuine issues of material fact regarding the control status of the defendants).

181. *Id.*

182. *Id.* The court explained that "[i]naction alone cannot be the basis of liability; defendants' inaction must be deliberate and done intentionally to further the fraud." *Id.* (citations omitted).

183. See *id.* at 519.

184. See *id.*

185. The court noted that the plaintiffs' proof relating to scienter satisfied the culpable participation standard. See *id.* at 506-10. That proof revealed evidence that certain defendants, outside directors, knew of the company's financial infirmities at the time the company released financial statements that failed to disclose sufficiently these infirmities. *Id.* at 507-08.

participation standard.¹⁸⁶

B. *Liability of Officers Who Fail to Sign Periodic Reports*

1. Primary Liability

Arguably, requiring executive officers to certify forms that they previously were not obligated to sign expands the potential liability of such officers. As noted, current instructions only require the CEO to sign the 10-K.¹⁸⁷ By extending certification to the 10-Q, the Sarbanes Act appears to have a significant impact on the liability exposure for CEOs.

Under existing law, by failing to sign the 10-Q, CEOs do not make a statement attributable to them, and hence may escape liability as a primary violator of the securities laws. The Supreme Court's 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*¹⁸⁸ held that only persons who engage in deceptive activity or make an affirmative statement may be subject to liability under Section 10(b) and Rule 10b-5 of the Exchange Act.¹⁸⁹ Courts interpreting this decision agree that defendants who make a statement attributable to them, such as accounting firms that sign financial reports, can be held liable as primary violators of the Exchange Act.¹⁹⁰ Thus, *Central Bank* appears to support opinions that impose primary liability on officers who sign periodic reports. Hence, the CFO, who must sign both the 10-K and the 10-Q, makes a statement that could subject him to liability. Similarly, the CEO makes a statement when she signs the 10-K. By contrast, because the Exchange Act does not require the CEO's signature on the 10-Q,

186. See, e.g., *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1442 (9th Cir. 1987) (noting that the defendants—including the chief executive officer and a controller—had direct involvement in the daily affairs of the company and were responsible for preparing the company's books and records, and that these facts, coupled with the fact that they signed documents containing misrepresentations, made them liable as control persons under the culpable participation test); *In re Indep. Energy Holdings PLC*, 154 F. Supp. 2d at 773 (stating that the plaintiff had to allege facts that reveal the defendant knew or should have known of fraudulent conduct in order to satisfy the culpable participation test); *In re Fine Host Corp.*, 25 F. Supp. 2d at 73 (plaintiffs' allegations that defendants held a high level position and had intimate knowledge of financial affairs sufficient to establish culpable conduct).

187. See *supra* notes 69-71.

188. 511 U.S. 164 (1994).

189. *Id.* at 191.

190. See, e.g., *McGann v. Ernst & Young*, 102 F.3d 390, 397 (9th Cir. 1996) (holding accounting firm liable for audit report which it signed that was included in its client's 10-K); *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 486 (3d Cir. 1994) (recognizing liability for misrepresentations in opinion letters, even if based on representations by client).

she does not make a statement in connection with that report. Unfortunately, *Central Bank* triggered disagreement amongst the circuits about the potential liability of defendants, such as CEOs, who do not sign a document or otherwise make a statement that can be attributed to them.¹⁹¹ Some courts claim that a corporate officer can be held liable under Rule 10b-5 when she substantially participates in the preparation of a document, but does not sign that document.¹⁹² Other courts adopt a “bright line” approach, maintaining that such defendants cannot be held liable as primary violators.¹⁹³ Under the latter approach, the CEO avoids primary liability for the 10-Q if she does not sign it.

Then too, even under the substantial participation approach, allegations that a defendant served in an executive office and knew of fraudulent information contained within a report may be insufficient to prove liability.¹⁹⁴ Thus, one court noted, “the Supreme Court’s opinion in *Central Bank* makes clear that more than simply knowing assistance with the underlying fraudulent scheme is required for Section 10(b) liability.”¹⁹⁵ Therefore, such liability requires more than allegations that the defendant knew that the company for which she worked had issued fraudulent statements.¹⁹⁶ Thus, even the substantial participation test distinguishes signatories, who are subjected to liability for their knowledge, and non-signatories, who can avoid liability even when they know of the misleading nature of a report. This demonstrates that both the bright line test and the

191. See, e.g., *Ziemba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (noting that “[f]ollowing *Central Bank*, the federal courts have split over the threshold requirement” for holding secondary actors liable under Section 10(b) and Rule 10b-5 of the Exchange Act).

192. See *id.* at 1205 (primary liability under Section 10(b) and Rule 10b-5 must be based on a misstatement or omission publicly attributable to defendants; allegations related to a defendant’s role in drafting or reviewing documents insufficient); *In re Software Toolworks, Inc.*, 50 F.3d at 628 (primary liability under Rule 10b-5 may be imposed on those people who substantially participated in the preparation of fraudulent statements); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 433 (N.D. Ill. 1995) (primary liability could be based on accountant’s role in drafting misrepresentations); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (evidence of defendant’s intricate involvement in statements sufficient to show primary liability).

193. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2nd Cir. 1998) (“a secondary actor cannot incur primary liability . . . for a statement not attributed to that actor at the time of its dissemination”); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (“Allegations of ‘assisting’ or ‘participating in’ . . . fall within the prohibitive bar of *Central Bank*”); *Anxieter v. Home-Stake Production Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996) (secondary actors must make a statement that they know or should know will reach the public in order to be primary violators).

194. See *In re ZZZZ Best*, 864 F. Supp. at 967-68.

195. *Id.* at 969.

196. See *id.* at 969-70.

substantial participation test may foreclose liability for some officers when they do not sign the 10-Q.

By contrast, some courts explain that CEOs who do not sign documents, but actively participate in the preparation of such documents, can be held liable as primary violators. In *Carley Capital Group v. Deloitte & Touche*,¹⁹⁷ the court noted that *Central Bank* did not limit liability to those who signed documents.¹⁹⁸ Instead, adopting an approach favored by the SEC, the court reasoned that a defendant who creates a misrepresentation alone or with others can be held liable as a primary violator.¹⁹⁹ In the court's view, this required more than mere participation or assistance, but allegations that a defendant created the misrepresentation, even if not publicly attributed to the defendant.²⁰⁰ The court found that the plaintiffs met this requirement when they alleged that the defendant created the misrepresentation by directing the company to include misleading data in a periodic report.²⁰¹ This means that a CEO who causes misleading information to be included in a company's disclosure documents may be viewed as a primary violator of the securities laws. Other courts, adopting a more lenient approach, allow proof of a defendant's active participation in the drafting of documents to satisfy primary liability.²⁰² Thus, when defendants actively take a role in drafting and reviewing statements containing misrepresentations, courts in the Ninth Circuit have found that they could be liable under Section 10(b).²⁰³ From this perspective, CEOs who help to draft and prepare the 10-Q knowing that it contains false information can be subject to primary liability.

2. Secondary Liability

As noted previously, there are two approaches for control person liability. The culpable participation approach enables courts to impose control person liability only under a few circumstances, while the potential control test may have broader application to executives who do not sign misleading reports.

Indeed, like the substantial participation test, the fact that an

197. 27 F. Supp. 2d 1324 (N.D. Ga. 1998).

198. *Id.* at 1334. The SEC urged the court to adopt a standard that fell in between the bright line rule endorsed by the Second Circuit and the Ninth Circuit's more lenient approach, which enabled defendants to be viewed as primary violators if they took an active role in drafting, preparing or releasing a fraudulent document. *See id.*

199. *Id.*

200. *Id.*

201. *Id.* at 1334-35.

202. *See In re Software Toolworks, Inc.*, 50 F.3d at 615; *In re ZZZZ Best*, 864 F. Supp. at 970.

203. *See In re Software Toolworks, Inc.*, 50 F.3d at 615.

officer holds a high level position within a company and knows of the fraudulent conduct is not enough to establish derivative liability under the culpable participation standard. Thus, in *Paracor Finance, Inc. v. General Electric Capital Corp.*,²⁰⁴ the Ninth Circuit noted that while the defendant's position as an officer did not create a presumption of control, it was "a sort of red light."²⁰⁵ Despite this fact, the defendant, a CEO and chairman of the board, was not involved in the corporation's day to day activities.²⁰⁶ He also did not read, sign or prepare the fraudulent document at issue.²⁰⁷ Thus, the court found that the CEO could not fall under the scope of Section 20(a).²⁰⁸ In comparison, the court refused to dismiss the control person claim against a corporation's president who signed a document containing misleading information.²⁰⁹ Like some applications of primary liability, courts applying the culpable participation standard make a distinction between those who sign documents, and hence may automatically subject themselves to control person liability, and those who do not, and thus need to prove some greater level of involvement in the fraudulent activity. This narrows the potential liability for a CEO in relation to the 10-Q.

However, analysis of cases involving control person liability for officers who do not sign a document reveals that such officers may be exposed to such liability under at least three scenarios. First, under the culpable participation standard, a CEO who takes an active role in drafting the 10-Q may be exposed to liability. Indeed, a court in the Second Circuit found that control person liability could be imposed on a CFO who served as the head financial officer during the time his company issued fraudulent statements and worked on the transactions giving rise to the statements.²¹⁰ Second, as the previous section revealed, some courts apply a control by status method and enable plaintiffs to prove the control of a person by reference to their position within an organization. Under this approach, a CEO, as head of the corporation with responsibility for managing its affairs, has control for purposes of Section 20(a) even when she does not sign the fraudulent documents at issue. Third, the previous section also revealed that evidence of a person's position coupled with allegations that such person knew of inaccuracies within reports disseminated to the public is sufficient to prove control. For example, in *Metzger v.*

204. 79 F.3d 878 (9th Cir. 1996).

205. *Id.* at 890 (quoting *Arthur Children's Trust v. Keim*, 994 F.2d 1390, 1396 (9th Cir. 1993)).

206. *See id.*

207. *See id.* at 890-91.

208. *Id.* at 891.

209. *Id.* at 889.

210. *See In re CINAR Corp. Sec. Litig.*, 186 F. Supp. 2d 279 (E.D.N.Y. 2002).

American Food Management, Inc.,²¹¹ a corporation sold notes based on advertisements that contained material misrepresentations about the company's financial status.²¹² The defendants, who were officers and directors of the company, knew that the company was in a precarious financial state and were aware that the company was issuing notes, though they had no role in the issuance.²¹³ The court concluded that their position coupled with their failure to exert any pressure on the corporation to prevent the sale of the notes was enough to infer that they had condoned and participated in the fraudulent scheme.²¹⁴ This case reveals that a CEO who does not sign the 10-Q can be exposed to liability by virtue of her high-level position and knowledge of the fraud or inaccuracies within that 10-Q. *Metzger* demonstrates that even though a CEO fails to sign a given report or otherwise participate in its preparation, her position and knowledge means that she has the authority to influence those who did sign the report. Moreover, with respect to each of these scenarios, the CEO's knowledge of the fraud makes her ineligible for a good faith defense. In this way, she can be held liable as a control person for a document she did not sign.

C. Comparison with the Sarbanes Act

Taken together, Sections A and B reveal various avenues pursuant to which CEOs and CFOs may be subject to liability for their companies' periodic reports. Those sections indicate that courts subject an officer who signs a periodic report with knowledge of its inaccuracies to both primary and secondary liability. Those sections further reveal that in some jurisdictions, an officer's intricate involvement in, or knowledge of, a fraudulent scheme subjects him to primary liability even when he does not sign the fraudulent document at issue. In addition, even when a plaintiff cannot establish primary liability because an officer was not a signatory on a given report, his knowledge and position may expose him to secondary liability. Consequently executive officers face considerable liability when they know about, or approve of, fraudulent statements within periodic reports.

Each of these standards appears strikingly similar to liability imposed under the Sarbanes Act. Primary liability for signatories under Section 10(b) and Rule 10b-5 of the Exchange Act reflects the

211. 389 F. Supp. 469 (W.C. Pa. 1975).

212. *Id.* at 470.

213. *Id.* at 470-71. The defendants served as secretary-treasurer and vice president of the company. *Id.* at 470.

214. *Id.* at 471 (noting that the defendants' positions conveyed control, that defendants were aware of the company's precipitous financial position, and did not exert any pressure to prevent the issuance of the notes).

clearest similarity with the Sarbanes Act. *Howard* reveals that Rule 10b-5 of the Exchange Act subjects CEOs and CFOs who sign periodic reports with knowledge of their falsehood to liability.²¹⁵ While *Howard* indicates that merely signing a report cannot form the basis for primary liability,²¹⁶ it also makes clear that an officer who signs the report with scienter – knowledge or recklessness – does face liability.²¹⁷ Similarly, the Sarbanes Act does not impose strict liability on officers who certify financial statements. Instead, in order to be held liable under the Sarbanes Act, a plaintiff must prove that officers who certified the financial statements knowingly violated the provision.²¹⁸ This appears no different than the rule pronounced in *Howard*. In fact, the SEC cited *Howard* for the proposition that the certification requirement does not impose any additional responsibility or liability on a signing officer.²¹⁹

Then too, the Sarbanes Act parallels existing standards for control person liability against executive officers responsible for signing periodic reports. Under the most lenient potential control approach, courts reason that an officer's status justifies imposing control person liability.²²⁰ Other courts impose liability based on an officer's status and his role as a signatory.²²¹ Still other courts, applying either the culpable participation standard or the potential influence model, impose control person liability based on the fact that an officer occupies a high level position and knows of the misleading information within a report he signs.²²² Regardless of which standard a court utilizes, signatories' lack of knowledge will enable them to avoid liability because such an absence indicates good faith.²²³ Taken together, the analysis related to control person liability reveals that

215. *Howard*, 228 F.3d at 1061-63.

216. *See id.* at 1062-63 (mere signature insufficient for Section 10(b) liability). *See also supra* note 105 (citing cases that support this proposition).

217. *See Howard*, 228 F.3d at 1062.

218. *See* Pub. L. No. 107-204 § 906, 116 Stat. 806.

219. *See Disclosure Certification*, 67 Fed. Reg. at 41879 n.31. The Act's certification requirement could have an unintended consequence of negating liability. Thus, if one takes seriously the argument that the new certification requirement alters standard for liability, then presumably officer and directors who signed a form with knowledge of its inaccuracy could not be held liable for securities fraud violations. Only the corporation could be held liable. This would mean that the corporation would receive a fine, and ultimately shareholders would have to pay twice for the misconduct. Clearly it is important that the SEC maintain its position that the new certification requirement acts as a restatement of the existing law as opposed to any dramatic change.

220. *See supra* note 127 and accompanying text.

221. *See supra* notes 145-48 and accompanying text.

222. *See supra* note 149 and accompanying text.

223. *See supra* notes 157-159 and accompanying text.

executives who sign reports with knowledge of their inaccuracies expose themselves to secondary liability. In this same vein, the Sarbanes Act reveals that merely holding a position of control, such as CEO or CFO, while certifying a report, does not subject one to liability. Instead, that Act requires proof of knowledge in order to hold an officer liable.²²⁴ This comparison demonstrates the symmetry between the Sarbanes Act and the existing rules governing control person liability for signatories.

This symmetry is significant given that existing guidelines require the CEO and CFO to sign most periodic reports. Indeed, because the CFO must sign both the annual report and the quarterly report, the Sarbanes Act does not appear to alter his potential for personal liability on these reports. The same is true with respect to CEOs who must sign the 10-K. The only area in which an executive officer currently may be shielded from liability is the 10-Q.

In fact, the Sarbanes Act may present an expansion of primary liability for CEOs who do not sign the 10-Q. Under the substantial participation test, some courts impose primary liability on CEOs who actively participates in the preparation of fraudulent documents.²²⁵ However, their mere knowledge of the fraud will not suffice.²²⁶ Instead, officers must play an active role in the fraud in order for courts to impose liability on them under the substantial participation test.²²⁷ However, by requiring certification, the Sarbanes Act imposes liability on these officers regardless of their level of involvement in preparing disclosure documents. Indeed, under the Sarbanes Act, mere knowledge of fraudulent information will suffice to hold an executive officer liable. This fact highlights the difference between the existing rules and the new act. Then too, under the bright line test, such officers do not make a statement under Rule 10b-5, and hence will avoid liability completely in courts that apply this test.²²⁸ By contrast, the Sarbanes Act's requirement that CEOs certify the 10-Q not only ensures that such officers make a statement regarding the financial information within the 10-Q, but also ensures that such officers make a statement for purposes of 10b-5 liability. Hence, that Act appears to significantly broaden the CEO's potential liability as related to the 10-Q.

However, the liability scheme for control persons reveals that CEOs may face derivative liability for forms that they do not sign, but know to be inaccurate. Certainly the culpable participation

224. See Pub. L. No. 107-204 § 906, 116 Stat 806.

225. See *supra* note 190 and accompanying text.

226. See *id.*

227. See *id.*

228. See *supra* note 193 and accompanying text.

standard reveals that many CEOs could escape liability if they do not have an active role in preparing the 10-Q.²²⁹ Yet such a standard represents a minority position, and one that appears to be gaining less favor among the circuits.²³⁰ The majority view reveals the significant likelihood that most courts would impose liability on these officers either because of their status or because they have the knowledge that allows them to correct fraudulent disclosures.²³¹ Once again, this approach is similar to the Sarbanes Act where officers who hold an executive position face liability for knowingly certifying inaccurate reports.

Some may argue that the Sarbanes Act expands all officers' potential liability because it requires the officers to make an affirmative statement regarding the specific information contained within the periodic report. As previously noted, Section 302 requires executives to certify that the periodic report "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading."²³² Because a similar statement does not appear on the signature lines of the periodic reports, the existing signature requirements appear to be "nominal."²³³ However, this appearance is deceiving. Indeed, the substantive language of the certification under Section 302 mirrors the language of Rule 10b-5.²³⁴ That rule forms the basis for securities fraud claims under cases like *Howard*. Clearly, courts subjected signers to the provisions of that rule even without a substantive statement to that effect. In this respect, the certification provision appears redundant. At the very least, this analysis strongly suggests that the certification fails to alter the obligations an officer undertakes when he signs a periodic report.

D. Comparison of Criminal Penalties Imposed upon Executive Officers

Arguably the true difference between the Sarbanes Act and the existing signature requirements may lie not in the kind of liability such provisions impose, but rather in the fact that the Act comes with the threat of severe criminal sanctions. As noted in Part I, a knowing violation of the certification provision subjects an officer to a

229. See *supra* notes 204-208 and accompanying text.

230. See *supra* notes 170-177 and accompanying text.

231. See *supra* notes 123-126 and accompanying text.

232. See Pub. L. No. 107-204 § 302(a)(2), 116 Stat. 777.

233. See *Bush Speech*, *supra* note 7 (defining existing rules as requiring CEOs to sign a "nominal" certificate).

234. See *supra* note 102 (stating text of Rule 10b-5).

\$1 million fine, 10 years in jail, or both, while a willful violation comes with a \$5 million fine, 20 years in jail, or both.²³⁵ Such sanctions can impact executive behavior by serving to deter fraudulent conduct.²³⁶

However, violators of the securities laws faced criminal liability even prior to the Sarbanes Act. Under the Exchange Act, any person who willfully violated any provision of the Exchange Act and any person who knowingly and willfully made or caused to be made false or misleading statements faced a \$1 million fine, 10 years in prison, or both.²³⁷ These provisions apply to those who violate Rule 10b-5 or Section 20(a) of the Exchange Act. Moreover, they mimic the liability associated with the first tier of Section 906 of the Sarbanes Act. Then too, under mail and wire fraud statutes, defendants faced up to ten years in prison if they use the mail or wire in connection with the fraud.²³⁸ Hence, executive officers who knowingly signed or approved periodic reports not only violate securities laws, but face criminal liability for their violation.

Of course the penalties under the Sarbanes Act are significantly higher than those associated with existing securities laws. In fact, the maximum criminal fine under the Sarbanes Act is five times that of the one under the Exchange Act,²³⁹ while the Act doubles the maximum jail time a defendant may receive for certifying a periodic report.²⁴⁰ Hence, it is not accurate to claim that there is no distinction between the amount of criminal liability imposed under the Sarbanes Act and that under the Exchange Act. However, in light of the similarities between the standard of liability between those two acts, the issue remains whether the difference in criminal penalties represents a significant enough change to deter undesirable conduct or otherwise hold executives accountable for corporate financial information.

III. THE PROMISE OF CERTIFICATION: RHETORIC OR REAL REFORM?

Part II revealed that current law subjects CEOs and CFOs to personal criminal liability for signing reports with knowledge that

235. See Pub. L. No. 107-204 § 906, 116 Stat. 806 (providing maximum penalties under proposed 18 U.S.C. § 1350).

236. See *infra* notes 287-317 and accompanying text (describing deterrence value of increased criminal sanction).

237. See Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1994).

238. Prior to the Sarbanes Act, a defendant faced a maximum prison term of five years for violation of the mail fraud statute, and a maximum prison term of five years for violation of the wire fraud statute. See 18 U.S.C. § 1341, 1343 *amended by* P.L. 107-204, Title IX, § 903, 116 Stat. 805 (2002).

239. See *supra* notes 86-87 (describing criminal penalties under Sarbanes Act).

240. See *id.*

they contain inaccuracies and, in some circumstances, for allowing misleading reports to be filed even when they do not serve as signatories. Such an assessment makes the current law in this context similar to that under the Sarbanes Act. What are the implications of this assessment? This similarity suggests a reason to be extremely pessimistic about the Act's ability to impact future officer misconduct. Indeed, if current law already imposed liability for knowingly signing or allowing reports to be filed, and it failed to prevent the current corporate scandals, a reform that only mimics current law may have similar implications.

One may argue that the certification requirement closes the loophole left by existing interpretations of liability related to executive officers. In this regard, the Sarbanes Act clears up the disagreement triggered by *Central Bank* over the liability of officers who do not sign or otherwise make statements attributable to them.²⁴¹ The Act also clears up any ambiguity related to control persons who do not sign a document or otherwise involve themselves in culpable conduct.²⁴² Because it was possible under existing law for some executive officers to avoid liability for their company's inaccurate financial documents, the Sarbanes Act can be viewed as foreclosing this possibility.

The value of the new certification also may stem from the fact that it forces officers' attention on their potential liability in a manner that the existing signature requirements do not. The SEC, while acknowledging that the liability imposed under a certification requirement may be similar to existing law, maintains that altering the signature requirement through certification may compel officers to pay greater attention to the information within their company's reports.²⁴³ Indeed, in its previous proposals for a certification requirement, the SEC has stated that certification does not create a new standard of liability, but rather focuses signers on their existing

241. See *supra* notes 189-191 and accompanying text (explaining that when courts apply the bright line test, they only impose liability on officers who sign periodic reports).

242. See *supra* notes 202-06 and accompanying text (describing courts application of the culpable participation test, and the fact that such application may exclude from liability those defendants who sign a periodic report without participating in fraudulent activities).

243. The SEC asserted, "[w]e do not believe that the proposed certification requirement would change the underlying liability standard. . . . These senior officers already are responsible as signatories for their company's disclosures under the Exchange Act liability provisions. . . . The proposed certification requirement would reinforce the responsibility of these corporate officers to security holders for the content of companies' quarterly and annual reports." *Disclosure Certification*, 67 Fed. Reg. at 41879.

liability.²⁴⁴

Certainly the requirement has garnered the attention of the business community. Referring to the certification as a “non-event,” some executives maintain that certification is no different from signing periodic reports, and that it does not expose them to any additional liability.²⁴⁵ Despite this lack of difference, a certification requirement does appear to cause executives to pay greater attention to the information contained within their disclosure documents.²⁴⁶ Thus, after the SEC announced its certification requirement, several companies filed their certifications early, while others filed even when they were not required to do so.²⁴⁷ Executives in these companies explained that certification enabled them to demonstrate their commitment to proper corporate governance, thereby restoring investor confidence in their companies.²⁴⁸ Other executives explained

244. See SEC Release No. 33-7606A at sec. XI.C(1) n.554 (Nov. 13, 1998) available at <http://www.sec.gov/rules/proposed/337606a1.txt> (last visited Dec. 15, 2002) (noting that the signature requirement would impose an added measure of discipline).

245. See Dawn Gilbertson, *CEO Filing Deadline Nears: New Rules Force Execs to Certify Finances*, ARIZ. REP., Aug. 4, 2002, at D1 (noting that most CEOs and CFOs say that the certification is no different from signing the quarterly and annual SEC reports, with some calling the certification a “non-event”). The author also notes that “few executives feel they’re anymore on the hook than they already were.” See *id.*

246. See *id.* (noting that certification increase the visibility of executive’s responsibility).

247. See Jonathan D. Glater, *Corporate Certifications Don’t Alone Lift Shares*, N.Y. TIMES, Aug. 20, 2002, at C11 (noting that Safeway filed earlier than it had to); Kirstin Downey Grimsley, *Deadline Nears to Certify Accounting: Some D.C. Area Firms Have Already Filed Statement with SEC*, WASH. POST, Aug. 12, 2002, at E4 (noting that some companies, like Marriott International, Inc., filed prior to the deadline, while others like Fannie Mae voluntarily filed even though they were not required to do so until 2003); Walter Hamilton, *CEOs are Diving for Legal Cover*, L.A. TIMES, July 22, 2002, at C1 (reporting that the CEO of Delphi Corp., the first company to file the SEC’s certification, claimed that the rule enabled him and other corporate executives to send a clear message to investors that they stand behind their company’s numbers); Krissah Williams, *SEC Still Tallying Certifications by CEOs*, WASH. POST, Aug. 17, 2002, at E1 (noting that the SEC’s web-site maintains that many firms filed certifications that were not required to do so until the end of the year). This voluntary reform on the part of the business community was also reflected in the voluntary codes of conduct announced by many business members including the Business Roundtable and the U.S. Chamber of Commerce. See Lee Walczak, et al., *Let the Reforms Begin*, BUS. WK., July 22, 2002 at 26. In fact, the Business Roundtable issued a press release stating, that it “strongly supports” the bill and “will quickly implement the changes to strengthen our companies’ governance.” See *The Business Roundtable Strongly Supports President Bush’s Signing of Accounting and Financial Reform Law*, July 30, 2002, available at <http://www.brt.org/press.cfm/748> (last visited Dec. 15, 2002) (statement of John T. Dillon, chairman of The Business Roundtable).

248. See Grimsley, *supra* note 247, at E1 (noting some executives’ belief that the certification enables companies to restore trust and confidence in the accuracy of their disclosures).

that the certification requirement caused them to review more extensively company financial information.²⁴⁹ In connection with such a review, companies instituted new procedures, such as holding week long due diligence sessions or requiring subordinate officers to certify the accuracy of certain information.²⁵⁰ These measures enabled companies to find and correct mistakes,²⁵¹ while prompting other companies to disclose information that they may not otherwise have provided to investors.²⁵² This suggest that certification can have its desired impact, not only causing companies to analyze more closely information within their periodic reports, but also improving the overall quality of information that such companies disclose. Then too, the certification has caused many executives to be more cautious with regard to attesting to financial information. Thus, several executive officers have refused to certify their periodic reports, arguing that they cannot certify the accuracy of the information within them.²⁵³ Even this refusal suggests that a certification requirement can have a positive impact on company's disclosures. Indeed, prior to such certification requirement, these companies may have filed reports with misleading information because executive failed to adequately review them. However, certification has forced these executives to take a realistic look at their company reports, and provide investors with a realistic assessment of their veracity. These responses to the SEC's certification requirement suggests that the analogous provision in the Sarbanes Act will have the ability to focus officers on the importance of verifying the accuracy of their company's financial statements prior to disseminating such

249. See Gilbertson, *supra* note 245, at D1 (noting that "CEOs and CFOs are checking and rechecking math, assumptions and disclosures up and down the chain of command"); Hamilton, *supra* note 247, at C1 (noting that the certification has prompted CEOs to re-check their accounting procedures and require subordinates to sign statements under oaths).

250. See Hamilton, *supra* note 247, at C1.

251. See Kathleen Day & Krissah Williams, *CEO Deadline Brings Some Restatements: Accounting Certifications Overload SEC Staff*, WASH. POST, Aug. 15, 2002, at A8 (revealing one company that found \$68.5 million in charges that had not been accounted for, while others made miscalculations).

252. See Day & Williams, *supra* note 251, at A8 (noting some reports which detailed the extent to which senior management had relatives who worked at the company).

253. See Williams, *supra* note 247, at E8 (several companies, including those in the spotlight, such as Adelphia, will not certify their companies' reports); Day & Williams, *supra* note 251, at A8 (companies involved in the recent scandals, such as Enron and Qwest, will not file certifications). The certification also may have negative consequences. Hence, the Wall Street Journal recently reported that several executives have refused positions at corporations because of concern about the certification requirement, and their possible liability. See Phyllis Plitch, *Auditor Letters Now Worrisome for Executives*, WALL STREET JOURNAL, Oct. 16, 2002 at Sec. B, Page 3A.

documents to the public.²⁵⁴

Moreover, to the extent that augmenting criminal sanctions serves to deter undesirable behavior, the Sarbanes Act may prove useful because it dramatically increases the criminal sanctions of corporate executives. The Act not only doubles the existing Exchange Act penalties for signing false reports under the Exchange Act,²⁵⁵ but also creates new criminal liability for making a false certification.²⁵⁶ Further, it quadruples the maximum jail time for defendants found liable for mail and wire fraud.²⁵⁷ Because these penalties are cumulative, they represent a significant increase in a defendant's potential liability for signing or otherwise sanctioning misleading periodic reports.

However, the threat of such sanctions is only as good as their potential to be realized. Professor John Coffee notes that the consensus of criminologists is that we best deter economic crimes by ensuring that criminals are likely to be apprehended and that their apprehension will lead to the imposition of significant penalties.²⁵⁸ In agreement, the former secretary of the U.S. Treasury and former chairman of the Federal Reserve Board noted that "the most Draconian penalties will not deter wrongdoing if the perpetrators believe that the penalties will not be enforced."²⁵⁹ The Assistant U.S. Attorney General, Criminal Division, agreed with these sentiments.

254. See Grimsley, *supra* note 247, at E4 (a former corporate finance lawyer at the SEC noted that the certification requirement "personalizes" the job of the corporate executive).

255. As this Article demonstrates, a defendant who signed or otherwise approved a periodic report containing fraudulent information could be held primarily liable under Section 10(b) and Rule 10b-5 of the Exchange Act, and secondarily liable as a control person under Section 20(a) of the Exchange Act. Section 32 imposes criminal penalties for the willful violation of either of those provisions. See Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1994). The Sarbanes Act increases the maximum sanctions under Section 32 from 10 years and a \$1 million fine to 20 years and a \$5 million fine. See Pub. L. No. 107-204 § 1106, 116 Stat. 810.

256. See Pub. L. No. 107-204 § 906, 116 Stat. 806 (providing for maximum 20 year sentence and \$5 million fine).

257. See Pub. L. No. 107-204 § 903(a)-(b), 116 Stat. 804 (amending mail and wire fraud statutes to increase the maximum penalty from five years to twenty years).

258. See *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?: Hearing Before the Senate Judiciary Comm.*, July 10, 2002 (statement of Professor John C. Coffee, Jr.), available at http://www.senate.gov/~judiciary/print_testimony.cfm?id=310&wit_id=711 (last visited Dec. 15, 2002).

259. *Criminal Sanctions for Corporate Wrongdoing, Hearing Before the Senate Judiciary Comm.*, July 24, 2002 (statement of Hon. G. William Miller) available at http://www.senate.gov/~judiciary/print_testimony.cfm?id=329&wit_id=766 (last visited Dec. 15, 2002) (noting that for the corporate wrongdoer, the only effective deterrent is one in which the probably of serious punishment is high, and that the most powerful deterrent is the threat of jail time).

We believe that strong enforcement and tough penalties are especially important in the context of white collar crimes, because business criminals act with calculation rather than in a fit of anger or compulsion. Because white collar criminals act more rationally than most other criminals, they can more easily be deterred. In our experience, one thing is crystal clear: businessmen and women want to avoid jail at any cost. If their calculus includes a reasonable likelihood that they will be caught, and if caught, a reasonable likelihood that they will go to jail rather than get probation, home detention, or some other “alternative to incarceration,” they will be much less willing to roll the dice and commit a fraud.²⁶⁰

Hence, while augmenting the maximum sentences of corporate defendants may be important, experts suggest that deterrence may only be achieved if this augmentation is coupled with meaningful. Yet the current regime appears to have failed in this regard. Securities experts pinpoint at least two reasons for this failure. The first reason stems from the difficulty of proving the necessary criminal intent of high-level officers, which in turn decreases the probability that such officers will be found liable for securities fraud. The second reason rests on the systems’ failure to subject corporate wrongdoers to severe criminal sanctions. The next sections will analyze these defects, and determine if the Sarbanes Act can overcome them.

A. *What You Don’t Know Can’t Hurt You: Examining the Difficulties with Proving Criminal Intent*

Prosecutors must establish criminal intent in order to hold corporate managers liable for securities fraud. Similar to civil law, prosecutors must prove that a defendant acted with the requisite intent.²⁶¹ As with civil law this means that prosecutors must show

260. See *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?: Hearing Before the Senate Judiciary Comm.*, July 10, 2002 (statement of Hon. Michael Chertoff) available at http://www.senate.gov/~judiciary/print_testimony.cfm?id=310&wit_id=66 (last visited Dec. 15, 2002).

261. In civil cases, the Supreme Court has held that plaintiffs must prove that the defendant acted with scienter. See *Ernst & Ernst*, 425 U.S. at 194 (defining scienter as “a mental state embracing intent to deceive, manipulate or defraud”). See also *Aaron v. SEC*, 448 U.S. 680, 691 (1980) (holding that the SEC must prove scienter in an action for injunctive relief). The Exchange Act defines the level of intent necessary for criminal prosecution as willfulness. See Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1994). The Supreme Court defines intent as scienter similar to that required with respect to civil cases. See, e.g., *U.S. v. O’Hagan*, 521 U.S. 642, 647 (1997) (defining willfulness as intentional doing of a wrongful act). The Exchange Act allows defendants to escape imprisonment if they have no knowledge of the Act’s provisions. See Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1994). However, as one commentator

that the defendant acted with knowledge,²⁶² or with reckless disregard,²⁶³ of fraudulent conduct. Unlike civil cases, prosecutors must establish a defendant's criminal intent beyond a reasonable doubt.²⁶⁴

According to securities officials, proving that top level corporate officials possess the criminal intent necessary for securities fraud poses a challenge, making the successful prosecution of such cases extremely difficult. Indeed, unless there is a smoking gun or confession, establishing an executive's knowledge or recklessness represents an uphill battle.²⁶⁵ Cases involving financial fraud are

notes, "the theoretical ability to escape imprisonment under section 32 of the 1934 Act has not proven to be of much practical use." Norwood P. Beveridge, *Is Mens Rea Required for a Criminal Violation of the Federal Securities Laws?*, 52 BUS. LAW. 35, 46 (1996). Indeed, given the general awareness of the securities fraud provisions, it is difficult for defendants to establish their lack of knowledge of those provisions. *See id.* Ultimately, commentators agree that aside from the burden of proof, the requirements for proving securities fraud in the criminal context are coextensive with the requirements in the civil context. *See id.* *See also* Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1043.

262. *See, e.g.*, O'Hagan, 521 U.S. at 647 (intentional doing of wrongful act). *See also* Beveridge, *supra* note 261, at 46, 57 n.138 (in order to prove willfulness, prosecutors must establish knowledge). Knowledge also must be proven in the civil context. *See Ernst & Ernst*, 425 U.S. at 197 (noting that scienter includes knowing or intentional misconduct).

263. *See, e.g.*, *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (willfulness can be established by recklessness – proof that fraud was so obvious that defendant must have been aware of it); *U.S. v. Gruenberg*, 989 F.2d 971, 974 (8th Cir. 1993) (prosecutors must establish knowledge or that the defendant deliberately closed his eyes to the fraud); *U.S. v. DeVea*, 734 F.2d 1023, 1028 n.2 and 1028 n.3 (5th Cir. 1984) (citing *U.S. v. Jewell*, 532 F.2d 697 (9th Cir. 1976)) (reckless conduct – when a defendant deliberately closes his eyes to fraud – is sufficient to establish criminal intent); *U.S. v. Weiner*, 578 F.2d 757, 787 (9th Cir. 1978) (intent may be demonstrated through recklessness or deliberate indifference, defined as acting with awareness of high probability of the existence of fraud). *See also* Sachs, *supra* note 261, at 1053 (knowledge includes recklessness). In the context of civil cases, while the Supreme Court in *Ernst* declined to resolve whether recklessness satisfied the scienter requirement, *see Ernst & Ernst*, 425 U.S. at 193 n.12, the overwhelming majority of federal courts have concluded that reckless conduct suffices to establish scienter. *See, e.g.*, *Hollinger*, 914 F.2d at 1569; *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir. 1982); *Broad v. Rockwell International Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978); *Lanza*, 419 F.2d at 1306; *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790, 793 (7th Cir. 1977).

264. *See* Sachs, *supra* note 261, at 1043 (explaining that burden of proof in criminal context higher than civil context).

265. *See* Elizabeth Amon, *White Collar Crime: Heat Going Up? It's Tough to Prosecute CEOs – For Now*, NAT'L L.J., July 8, 2002, at A15 (quoting assistant U.S. attorney and chief of securities fraud unit in New Jersey who notes that often "there are few emails or memos" to prove that a CEO had knowledge about illegal accounting

complex, involving analysis of numerous documents and the transactions on which they are based.²⁶⁶ Moreover, it is not enough to establish that a defendant knew that accounting information contained in a periodic report violated generally accepted accounting principles (“GAAP”).²⁶⁷ Instead, a plaintiff must prove that a

practices); Jennifer Arlen, Commentary, *Forget New Laws – Fix the Old Ones; Bush’s Plan Shows He’s Not Serious About Addressing Business Fraud*, L.A. TIMES, July 10, 2002, at B13 (noting that it is very difficult to prove intent to fraud). In the civil context, the pleading rules exacerbate the problem related to proving intent because plaintiffs must plead specific facts necessary to establish scienter prior to discovery. In 1995, Congress passed the Private Securities Litigation Reform Act of 1995 (the “Reform Act”), Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4), which amended various provisions of the Exchange Act. The Reform Act, aimed at deterring merit less private law suits, or “strike suits,” see H. R. Rep. No. 104-369, at 31 (1995), requires that the plaintiff allege “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2) (1997). Courts have disagreed about the application of this pleading standard. Thus, consistent with its position prior to the Reform Act, the Second Circuit recently has maintained that a plaintiff could establish a strong inference of fraudulent intent in two ways: (a) by showing that the defendant had both the motive and opportunity to commit fraud, or (b) by providing strong circumstantial evidence of the defendant’s intentional or reckless behavior. See, e.g., *Kalnit v. Eichner*, 264 F.3d 131, 138-39 (2nd Cir. 2001) (noting that courts must analyze both methods when establishing scienter); *Novak v. Kasaks*, 216 F.3d 300, 307 (2nd Cir. 2000) (concluding that the Reform Act effectively adopted the pleading standards it had set out). However, the Ninth Circuit has rejected the “motive and opportunity” pleading standard, insisting that plaintiffs “plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.” *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999). Under either formulation, courts concur that the Reform Act heightened the pleading requirements. These requirements have an impact on a plaintiffs’ ability to successfully litigate securities fraud cases. In fact, some of the recent cases involving corporate wrongdoing have ended in dismissal because of the plaintiffs’ inability to plead the requisite intent. Thus, a district court recently dismissed a class action against the CEO and CFO of WorldCom for failure to plead fraud with particularity. See *In re MCI WorldCom, Inc.*, 191 F. Supp. 2d at 778. In that case, plaintiffs alleged that the officers issued statements regarding the financial status of WorldCom which were false or misleading because the statements included amounts related to uncollectible accounts that should have been written off. *Id.* The accounts represented \$325 million. *Id.* The court noted that the plaintiffs’ allegations failed to satisfy the heightened pleading burdens outlined by the Reform Act. See *id.* at 790. Because they impact the success of civil suits, and undermine shareholders’ ability to bring suit against corporate managers, some maintain that the pleading requirements undermine the overall effectiveness of securities laws. See Arlen, *supra*, at B13.

266. See *id.*; see also Marianne Lavelle, et al., *Payback Time? Seeking Retribution for Enron’s Losses Won’t Be Easy*, U.S. NEWS & WORLD REPORT, March 11, 2002, at 36 (quoting securities expert who explains that proof of fraud is often “buried in documents – sometimes hundreds of thousands of documents”).

267. See, e.g., *In re Cylink*, 178 F. Supp. 2d at 1082; *In re Fine Host*, 25 F. Supp. 2d at 69; *In re Health Mgmt., Inc.*, 970 F. Supp. at 203. Because the standard of intent in criminal and civil cases is the same, this Article will use cases in both contexts as illustrations.

defendant knew of the particular transactions underlying the accounting violations, and that the defendant knew or should have known that the violations represented a material misstatement of those transactions.²⁶⁸ This standard is difficult to meet even when the signatory is the one responsible for drafting the documents or consummating the transaction at issue.²⁶⁹ The standard is even more difficult as applied to top level officers.²⁷⁰ Indeed, executives are not required to have accounting agrees, and thus may not appreciate the nature of the accounting misrepresentations at issue. Also, such officers may operate behind the scenes, remaining uninvolved in the day to day operations of the company or in the specifics of transactions. In fact, many executives rely on other officers or experts to make decisions about the intricacies of such transactions. This reliance makes it difficult to prove that the executive had the kind of knowledge necessary to be held liable under the securities laws.

Even when executives do not have actual knowledge of fraudulent conduct, prosecutors can prove criminal intent by showing that they were reckless and ignored red flags. Courts define reckless conduct as conduct that is “highly unreasonable,” pursuant to which the danger is “so obvious that the defendant must have been aware of it.”²⁷¹ Yet even this standard may fail to encompass executives who take a hands-off approach to their companies. Thus, plaintiffs in *In re Cylink* sought to hold the company’s CEO liable for securities fraud based on allegations that the company, Cylink, Inc. (“Cylink”), had filed quarterly reports that overstated its revenues by \$13.5 million.²⁷² Plaintiffs could not prove that the CEO intentionally participated in the accounting fraud scheme at issue.²⁷³ Hence, they sought to hold him liable based on recklessness, arguing that the magnitude of the accounting errors revealed that he had ignored obvious red flags.²⁷⁴ The court agreed that the accounting fraud at

268. See, e.g. *In re Fine Host*, 25 F. Supp. 2d at 69 (noting that complaint involving accounting fraud must allege that the defendant was aware of false or misleading numbers of that she “deliberately avoided checking into the numbers because she suspected them to be false or misleading.”).

269. See Jim Oliphant, *Throwing CEOs in Jail No Easy Job*, LEGAL TIMES, July 12, 2002, at 1 (noting that the higher up someone is, the harder it is to charge them because they are often removed from the day to day activities of their companies).

270. See *id.*

271. See *Chill v. General Electric Company*, 101 F.3d 263, 269 (2d Cir. 1996). See also *Wonsover*, 205 F.3d at 414; *DeVeau*, 734 F.2d at 1028n.2.

272. See *In re Cylink*, 178 F. Supp. 2d at 1079 (noting that the company had overstated its revenue by \$7.8 million in the first quarter of 1998 and then overstated its revenues by \$5.7 million in the second quarter).

273. See *id.* at 1085.

274. See *id.* at 1083.

issue involved significant violations of GAAP's revenue recognition provisions.²⁷⁵ However, the CEO was not involved in any of the transactions upon which the violations were based, and apparently had no duty to review the periodic reports related to those transactions.²⁷⁶ As a result, the court concluded that he could not and should not have been aware of the mistakes.²⁷⁷ For this reason, his conduct was not reckless.²⁷⁸ This case suggests that unless an executive has a duty to oversee or monitor specific transactions, or is otherwise directly involved in the transaction, it may be difficult to establish that he should have been aware of misleading information regarding those transactions.²⁷⁹ As applied to CEOs, such a standard makes it difficult to prove that executives acted with scienter for purpose of the Exchange Act.

The problems associated with proving criminal intent ultimately impact the deterrence value of criminal sanctions. Michael Chertoff, the Assistant U.S. Attorney General, Criminal Division, emphasized the impact of these procedural hurdles on the law's ability to deter misconduct. In his view, "white collar criminals also count on their misdeeds being difficult both to detect in the first instance and ultimately to prove in court beyond a reasonable doubt. . . . For that reason, it is all the more important that corporate criminals realize that meaningful punishment lies at the end of the road to conviction."²⁸⁰

Just like existing law, the Sarbanes Act requires plaintiffs to prove knowledge, making it more difficult to find executives guilty of misconduct. In order to be held liable for violating the certification requirement, a defendant's conduct must be knowing or willful.²⁸¹ Not only is this similar to existing law, but courts may define such terms more narrowly with respect to the Sarbanes Act. Indeed, the Senate version of the Act allowed courts to impose a criminal penalty if a defendant's conduct was reckless.²⁸² However, Congress struck that

275. *See id.* (noting the magnitude of the violations).

276. *See id.* at 1085. Although plaintiffs maintained that senior management had a duty to review the information contained in the 10-Q, they did not allege that with respect to the CEO. *See id.* at 1086. Instead, they claimed that he had a duty to review financial trends, but the court appeared to dismiss such a claim. *See id.*

277. *See id.*

278. *See id.*

279. *See, e.g., In re Xerox*, 165 F. Supp. 2d at 216 (noting that recklessness can be demonstrated by showing that a defendant "failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud").

280. *See White Collar Crime Penalties, Hearing Before the Senate Judiciary Comm.*, July 10, 2002 (statement of Michael Chertoff), 2002 WL 2031885.

281. *See* Pub. L. No. 107-204 § 906, 116 Stat. 806.

282. *See* Public Company Accounting Reform and Investor Protection Act of 2002, H.R. 3763 § 906(a) (Engrossed Amendment as Agreed to by Senate) (allowing criminal

term from the final version, which some courts may interpret to mean that a defendant's intent can only be established by showing that defendant's knowledge. This standard is more exacting than current law, which allows proof of recklessness.

Despite this heightened standard, the internal control procedures required by the Sarbanes Act potentially may enable plaintiffs to overcome some of the problems associated with proving knowledge of a high level officer. Section 302 of the Sarbanes Act requires officers to certify that they have established internal controls to "ensure that material information relating to the issuer" is made known to them, and that they have evaluated the effectiveness of those controls.²⁸³ Section 302 further requires officers to report on any significant deficiencies or changes in the internal controls that could adversely impact the company's ability to report financial data.²⁸⁴ Because the Sarbanes Act makes signing officers responsible for ensuring that others within the company impart material information to them, it makes it more difficult for signatories to maintain that they had no knowledge of materially misleading information contained in a periodic report. Moreover, by placing the onus on executives to affirmatively report on defects in the control structure, the Sarbanes Act ensures that executives take responsibility even for their lack of knowledge. Thus, plaintiffs and prosecutors may be able to use the executives' certifications regarding internal controls, as well as his oversight responsibility for those controls, as evidence of his knowledge about material information. Then too, to the extent an officer concludes that there are no problems with the control mechanism, he may be deemed to have admitted that any and all material information should have been imparted to him. Indeed, some courts have held that plaintiffs demonstrate recklessness by showing that a defendant failed to review or check information that he had a duty to monitor.²⁸⁵ In this way, the Sarbanes Act may expand the kind of information that

sanction for defendant who "knowingly and recklessly" violated certification provisions).

283. Pub. L. No. 107-204 § 302(a)(4)(B), 116 Stat. 777. *See also* § 302(a)(4)(D) (requiring officers to certify that they have evaluated internal controls at least 90 days prior to the report).

284. *See id.* § 302(a)(5). Signing officers must certify that they have disclosed to the issuer's auditors and the audit committee all significant deficiencies in the operation of internal controls as well as any fraud that involves management of other employees with a significant role in the issuer's internal controls. *See id.* In addition, Section 404 directs the SEC to create rules requiring each 10-K to contain an internal control report that assesses the effectiveness of the internal control structure, presents management's analysis of those structures, and indicates those persons responsible for maintaining such structures. *See* Pub. L. No. 107-204 § 404, 116 Stat. 789.

285. *See, e.g., In re Xerox*, 165 F. Supp. 2d at 215-16 (*citing Novak*, 216 F.3d at 308).

courts reasonably expect that executives know or should have known. In fact, the SEC believes that a certification requirement can impact the kind of information presumed to be in an executive's knowledge.²⁸⁶ If so, the Act could have a tremendous impact on the successful prosecution of securities fraud cases, making it more difficult for defendants to avoid responsibility for false information within company documents, and thus improving the ability of criminal sanctions to deter executives' conduct.

B. Where There's A Will, There's A Way: Measuring the Endurance of the Political Will to Sanction White Collar Criminals

Even if the Sarbanes Act equips prosecutors with the tools to successfully prove knowledge and hence convict executives of securities fraud, the deterrence value of the criminal sanctions may be undermined if lawmakers fail to actively prosecute such executives. Historical evidence reveals that few white-collar fraud cases result in prosecution, and that successful conviction is often followed by relatively light penalties. This evidence in turn suggests one reason for the inability of criminal sanctions to deter corporate misconduct.

Evidence reveals that white-collar crimes have a relatively low probability of being prosecuted. Indeed, based on interviews with dozens of current and former federal prosecutors, lawyers and corporate executives, *Fortune Magazine* concluded that "few in America's top-floor suites and corporate boardrooms fear the local sheriff. They know the odds of getting caught."²⁸⁷ *Fortune Magazine's* review of Department of Justice ("DOJ") statistics revealed that in the ten years from 1992 to 2001, attorneys in the Justice Department declined to prosecute over 64% of the white collar criminal cases referred to them by the SEC.²⁸⁸ Admittedly, often U.S. attorneys may not accept referrals because they do not have the resources or manpower to focus on such cases, which are complex and lengthy.²⁸⁹ Such attorneys also may decline cases because they believe they cannot adequately prove criminal intent.²⁹⁰ Regardless of the reason,

286. See Hamilton, *supra* note 247, at C1 (noting that the SEC's goal with their certification requirement was to prevent CEOs from claiming that they were unaware of the financial minutiae).

287. Clifton Leaf, *Enough is Enough: White-Collar Criminals: They Lie They Cheat They Steal and They've Been Getting Away With it for Too Long*, *FORTUNE*, March 18, 2002, at 60, 64.

288. See *id.* at 68 (noting that SEC enforcement attorneys referred 609 cases to the Justice Department and of that number, the U.S. attorneys decided to do about 525).

289. See *id.* at 64.

290. See *id.* at 68.

the referral rate suggests that many executives can commit crimes without fear of prosecution. This fact undoubtedly increases the probability that executives will engage in criminal behavior.

Then too, even when prosecutors accept cases, the penalties imposed upon convicted defendants appear relatively light. Many of the cases accepted by U.S. attorneys lead to successful conviction.²⁹¹ However, the nature of the sentences imposed after conviction suggests that prosecution may not be worth the effort. Thus, one report indicated that only 40% of convicted white collar criminals receive jail time.²⁹² Indeed, many corporate executives involved in high-profile cases avoided jail time altogether. For example, although officers in Sunbeam and Waste Management were convicted of securities fraud that led to millions of dollars in shareholder losses, the officers received only civil fines or home detention.²⁹³ Moreover, even when a court imposes jail time, the amount of time imposed is relatively low as compared to the maximum sentence that could be imposed.²⁹⁴ Thus, one study revealed that in 1999 and 2000 the median sentence imposed on defendants convicted of securities fraud was just one year,²⁹⁵ while DOJ statistics indicate that the average time served for white collar crime offenders was 16 months.²⁹⁶ The

291. See *id.* (noting that 76% of the cases that U.S. attorneys take end up with guilty verdicts).

292. See *id.* (describing data from Transactional Records Access Clearinghouse). Records reveal that 87 people spent time in prison.

293. See *id.* at 60. According to Fortune, officers at Sunbeam only face civil charges, and officers at Waste Management were assessed fines ranging from \$30,000 to \$50,000. See *id.*

294. See Oliphant, *supra* note 269, at 1 (noting that one CEO, convicted of a six-year scheme to fix prices, received a six-month in-home detention, while another figure served only 51 months in prison after pleading guilty to a savings and loan scam that cost Americans billions of dollars); *White Collar Crime Penalties, Hearing Before the Senate Judiciary Comm.*, July 10, 2002 (statement of Michael Chertoff), 2002 WL 2031885 (noting that “[n]ot only are the maximum statutory penalties for fraud and other white collar-type offenses substantially less overall than those for violent offenders or drug cases, but it appears that judges in some jurisdictions are overly willing to depart downward from the mandated federal sentencing guideline range to sentence such offenders to minimal (if any) jail time, home detention, or even probation.”).

295. See Walter Hamilton, *Crisis in Corporate America: More Time For Executive Crime: Already Tougher Sentencing Rules May Play Role in Latest Scandals*, L.A. TIMES, July 13, 2002, at C1. However, the sentences varied so that Michael Milken served 22 months in prison, while a president convicted of embezzling was sentenced to 19 years in prison).

296. See Leaf, *supra* note 287, at 60 (citing Department of Justice statistics). These studies are consistent with earlier findings by the U.S. Sentencing Commission that there were significant discrepancies between the punishment of white collar crimes like fraud and similar crimes such as theft. See Stephen Breyer, *The Federal Sentencing and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1, 16

lack of probability that executives will actually receive jail time coupled with the relatively minor sentences imposed may undermine the ability of criminal sanctions to deter undesirable conduct.²⁹⁷ In addition, the fact that defendants historically received no where near the maximum penalties for their crimes suggest that raising those penalties may prove ineffective in deterring such crimes.

Experts offer varying reasons for the tendency to treat white-collar criminals with kid gloves.²⁹⁸ Indeed, some maintain that crimes involving violence are more harmful to society and hence those who commit them are more deserving of harsh criminal sanctions as compared to those who commit white-collar crimes, which do not involve violence.²⁹⁹ Others argue that, to the extent that sanctions are designed to punish offenders, the process of investigation, trial and conviction represents sufficient punishment for white-collar criminals many of whom have no history of criminal behavior.³⁰⁰ Still others claim that because white-collar criminals have better resources, they are able to mount a better defense, thus avoiding harsh sanctions.³⁰¹ Regardless of the reasons, the evidence supports the conclusion that traditionally there has been relatively little pressure to impose significant punishment on white-collar criminals.³⁰²

Of course, the current climate reveals a political will to prosecute white collar criminals and impose significant jail time on those found guilty of wrongdoing. Thus, after charging them with various securities fraud, FBI agents handcuffed two corporate executives and led them past a horde of cameras to the federal district court house.³⁰³ Attorney General John Ashcroft emphasized the white house's

(1988).

297. See Oliphant, *supra* note 269, at 3 (citing George Washington Law Professor, who notes that judges' reluctance to impose harsh penalties makes executives less fearful of facing punishment).

298. See generally, WHEELER, MANN, & SARAT, *SITTING IN JUDGMENT: THE SENTENCING OF WHITE COLLAR CRIMINALS* (1988); Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PENN. L. REV. 1295 (2001).

299. See WHEELER, *supra* note 298, at 144 (noting that most judges contrast white collar crimes with violent crimes and believe that the violent crimes are more serious and more deserving of increased sanctions); J. Kelly Strader, *Judicial Politics of White-Collar Crime*, 50 HASTINGS L.J. 1199, 1264-65 (1999) (noting that most believe non-white collar crimes are more deserving of increased sanctions).

300. See WHEELER, *supra* note 298, at 144-45.

301. See Elizabeth Szockyj, *Imprisoning White-Collar Criminals?*, 23 S. ILL. U.L.J. 485, 487-88 (1999).

302. See WHEELER, *supra* note 298 (noting the willingness of judges to impose minimal, if any, sentences on white collar criminals).

303. See Carrie Johnson and Ben White, *WorldCom Arrests Made: Two Former Executives Charged With Hiding Expenses*, WASH. POST, Aug. 2, 2002, at A1.

approval of the arrest. "With each arrest, indictment and prosecution, we send this clear, unmistakable message: Corrupt corporate executives are no better than common thieves when they betray their employees and steal from their investors, . . . they will meet the judgment they fear and the punishment they deserve."³⁰⁴ This public display of arrests signals the government's desire to at least give the appearance that executives will face jail time for their misdeeds. Indeed, even politicians who would ordinarily oppose efforts aimed at increasing corporate officers' liability express support for these new measures.³⁰⁵ These politicians believe that their harsh treatment of offenders is necessary to restore investor confidence in the capital markets.³⁰⁶ Indeed, this was the sentiment expressed when the entire Senate and the overwhelming majority of the House passed new reform laws.³⁰⁷ Thus, Senator Oxley, the co-sponsor of the Sarbanes Act, announced that the act would "restore confidence in our markets. Investors can be assured that convicted corporate criminals will be sentenced to long jail time. In my view, the prospect of doing time, real time, will serve as an effective deterrent to wrongdoing in the corporate suite."³⁰⁸ President Bush mirrored this sentiment in his speech to Wall Street, calling for tougher criminal sanctions for executives who violate the public trust.³⁰⁹ In this way, the markets bolstered the political will to respond more diligently to white collar criminals.

Unfortunately, relying on political and market pressure to ensure successful deterrence of criminal sanctions may prove ineffective. This is because such pressures may be short term. Indeed, just a few years ago many lawmakers derailed attempts by then SEC Chairman Arthur Levitt to impose reform related to the accounting practices of many companies.³¹⁰ In fact, Chairman Levitt

304. *Id.*

305. See Jonathan Weisman, *Lobbyists Lose Clout; Business Groups Find Their Influence on Audit Reform Legislation Shrinking*, WASH. POST, July 23, 2002, at A1 (explaining pro-business Republican's reluctance to meet with accounting and corporate lobbyists); Walczak, *supra* note 247, at 26 (noting the conversion of many political leaders to support a reform effort, including the president and a big group of Senate Republicans).

306. See Staff Writers, *A One Day Wonder?*, WASH. POST, July 7, 2002, at H2 ("It's becoming clear that the Bush administration believes the best way to restore confidence in corporate America isn't to impose intrusive new regulations on businesses but to put misbehaving executives behind bars.").

307. See Christopher Stern & Carrie Johnson, *Congress Passes Law Targeting Abuse*, WASH. POST, July 28, 2002, at A3 (noting that the House passed the law 423-3 and the Senate passed the law 99-0, hoping that it would restore investor confidence).

308. *Conference Report*, *supra* note 11, at H5462 (statement of Sen. Oxley).

309. See *Bush Speech*, *supra* note 7.

310. See Weisman, *supra* note 305, at A1 (explaining that some of the same

sought to crackdown on some of the same companies that have come under fire today.³¹¹ However, when Chairman Levitt pushed for auditor independence rules, Wall Street accused him of “overreaching,” while many in Congress strenuously opposed his reform efforts.³¹² Moreover, even after Enron, many legislators were reluctant to institute serious reform measures, and thus stalled efforts to pass any such measures.³¹³ Reform efforts gained impetus only after the “wave” of scandals erupted over the summer of 2002.³¹⁴ Indeed, in the beginning of June some charged legislators with “losing their appetite” for aggressive reform and complained about the apparent victory of those who opposed reform measures.³¹⁵ Yet just a few weeks later, Congress passed the Sarbanes Act with virtually no dissent.³¹⁶ This reveals the swiftness with which legislators can change their positions on enforcement measures. Perhaps more telling is the charge by members of Congress from both houses that a few days after passage of the Sarbanes Act, the White House and the Department of Justice issued guidelines appearing to weaken key provisions of the Act, including provision related to securities fraud.³¹⁷ These charges raise concerns about lawmakers

lawmakers embracing the Sarbanes Act helped block Levitt’s reform effort).

311. See Jerry Knight, *Attention Focuses on AOL for Acquisitions, Alliances*, WASH. POST, October 5, 1998, at F7 (noting that AOL became the first company targeted for questionable bookkeeping, and that the CEO was targeting MCI WorldCom for its write-offs).

312. See Sandra Sugawara, *Deal Reflects Levitt’s Activism; SEC Chief in a Strategic Compromise on Audit Rule*, WASH. POST, Nov. 16, 200, at E1.

313. See David S. Hilzenrath, et al., *How Congress Rode a ‘Storm’ to Corporate Reform*, WASH. POST, July 28, 2002, at A1 (noting that just weeks before its unanimous passage in the Senate earlier few gave the Sarbanes Act much chance of being brought to the Senate floor). See also Ronald Brownstein, *Prospects Dimming For Post-Enron Reform Legislation*, L.A. TIMES, May 28, 2002, at A17 (noting prospects dimming for legislative reform and consideration of bills); Kathleen Day & Anitha Reddy, *Business Reform Gains Support in Senate, SEC: WorldCom Crisis Prompts Calls for Stronger Oversight Rules*, WASH. POST, June 27, 2002, at A12 (noting new support for bill was in contrast to opposition just a few weeks earlier); David S. Hilzenrath, *Senate Set For Action To Reform Audit Sector: Corporate Scandals Spur Call For Tougher Rules*, WASH. POST, July 7, 2002, at A1 (noting that in June the legislative furor over Enron had cooled and efforts to impose reform had died down); Richard Simon, *Senate Panel Approves Reforms For Corporations*, L.A. TIMES, July 12, 2002, at A20 (noting that after the reform bill had been stalled for months, it received a unanimous vote in the Senate); Richard Simon and Janet Hook, *The WorldCom Scandal: Bush Promises A Full Investigation By SEC*, L.A. TIMES, June 27, 2002, at A13.

314. See Hilzenrath, et al., *supra* note 314 at A1.

315. See Staff Writers, *Consumer Groups See Hill Letdown on Enron: Urge States to Step Into Breach*, SEC. WK., June 10, 2002, at 1 (noting that Congress appeared to be losing its appetite for aggressive reform measures).

316. See Stern & Johnson, *supra* note 307.

317. See Jonathan Weisman, *Some See Cracks in Reform Law*, WASH. POST, Aug. 7,

desire to impose the harsh sanctions outlined in the Sarbanes Act. Indeed, given that many politicians only appeared to support harsh criminal sanctions because of pressures from the market and the public, their desire to ensure that executives receive harsh punishment may be appeased by a few high profile arrests. Hence, while such pressures may ensure that certification has some short term impact, there remains the distinct possibility that it will have no long-term impact on corporate officers' behavior.

This analysis suggests that the Sarbanes Act may not be able to overcome the problems associated with the inability of criminal law to deter officers' misconduct. On the one hand, the Sarbanes Act's requirements related to internal controls may improve the ability of prosecutors to establish a defendant's knowledge, thus increasing the likelihood of success on the merits. To the extent corporate officials are more rational other possible criminals, this increased possibility may serve to deter their conduct. On the other hand, securities experts note that the effectiveness of any criminal sanctions may ultimately depend on the willingness of judges to impose harsh sentences on those who are convicted. Historically, we have not treated white collar criminals to the full measure of the law, imposing sanctions that are far below those allowed for under the law. While the political winds have shifted in favor of increased sanctions, it is possible for those winds to reverse. If this occurs, the ability of the Sarbanes Act to deter crime may be significantly weakened.

IV. CONCLUSION

The recognition that corporate managers' failure to take personal responsibility for the information within company disclosure documents may have a devastating impact on shareholders and the capital markets is not new. The SEC expressed their concern regarding the integrity of company disclosures in at least two major releases, and called for officers and directors to be more diligent in monitoring the financial information disseminated to the public. These calls apparently went unanswered. With the Sarbanes Act, will this third time prove the charm?

The Act's certification requirement represents one of its principal symbols of officer personal accountability, and hence examining its impact sheds light on the potential impact of the Sarbanes Act as a whole. This Article's analysis casts doubt on the ability of the certification requirement to achieve enhanced personal

2002, at E1 (noting that the White House and the Justice Department had issued interpretation and prosecution guidelines that, in the opinion of some Congressmen, weakened the bill's provisions, including those related to securities fraud).

accountability, a key objective of the Sarbanes Act.

This Article demonstrates that the Sarbanes Act's new certification requirement may do little to alter the legal responsibility officers faced prior to the act's enactment. Far from being nominal, an officer's signature on a periodic report subjects her to civil and criminal liability under the Exchange Act when she signs the form knowing that it contains material inaccuracies. This standard mirrors the liability imposed under the Sarbanes Act for officers required to certify their company's periodic reports. Even when a CEO does not sign a given form, she still faces control person liability if she is aware of discrepancies within the financial documents filed by her company. Such liability includes criminal sanctions. Thus, existing law imposes personal liability on executive officers in a manner very similar to the new certification.

On the positive side, the Sarbanes Act does require executive officers to maintain and certify the effectiveness of internal control procedures, and this requirement may lead to changes in officers' conduct. Demanding executives to take responsibility for internal controls within their companies ensures that such executives have knowledge, or can be presumed to have knowledge, of material defects within their companies' disclosure documents. This may enable securities officials to overcome the difficulties with proving criminal intent on the part of top level officers.

Despite this fact, the certification provision of the Act may prove ineffective because it depends upon the sustainability of both political and market pressure to impose harsh sanctions on white-collar criminals. Indeed, the critical distinction between the new certification and existing law is that the Sarbanes Act imposes severe criminal penalties on those who violate the certification provisions. Legislators maintain that these increased sanctions serve to deter corporate misconduct, while ensuring that executives are held personally—indeed criminally—responsible for such misconduct. Yet experts agree that criminal sanctions only serve to deter fraudulent conduct if the sanctions are adequately enforced. Traditionally, criminal sanctions for white-collar criminals were more symbolic than real reflections of the penalties an executive could expect a court to impose. Indeed, political and market forces did not pressure courts to impose significant jail time on white-collar criminals. As a result, even when convicted, such criminals received relatively light sentences, sometimes avoiding jail time altogether. Currently, there is political and market support for imposing tough criminal sanctions on white-collar criminals. However, this support may be short term. Indeed, there already exist signs that some officials may not feel compelled to impose the sanctions outlined under the Sarbanes Act. These signs undermine the possibility that the Sarbanes Act will

have a long-term impact on the conduct of corporate officers and their relative attentiveness to company disclosure documents. This limit on the certification requirement's ability to impact executives' behavior suggests that such a requirement may prove to be a form with no substance.