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NEW SECURITIES LITIGATION HAZARDS: THE RIPPLE EFFECTS OF SARBANES-OXLEY

by

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Since President Bush signed the Sarbanes-Oxley Act of 2002 ("Sarbanes") into law on July 30, 2002, public companies, their auditors and their lawyers have scrambled to meet the myriad requirements of the new law and the related SEC regulations adopted in its wake. As these overhauls take shape, it is evident that in addition to creating increased exposure to federal regulators and prosecutors, Sarbanes will affect how private litigation of federal securities cases and state law derivative actions is conducted. While it is impossible to predict all of the ways that creative plaintiffs' lawyers may use the provisions of Sarbanes to create or enhance causes of action, it is clear that the risk of litigation is increased for public companies, their directors and management in the wake of these sweeping reforms.[1]

Expansion of Private Rights of Action. It is abundantly clear that Congress intended to increase wrongdoers' exposure to private causes of action. Sarbanes extends the limitations period for private rights of action in claims involving "fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws." Instead of the prior 1year/3year limitations, claimants may now file these securities fraud actions within the earlier of two years from the discovery of facts constituting the violation or five years from the date of the violation. This change alone increases exposure to claims of wrongdoing for past conduct. Equally important, this extension almost certainly will lead to larger classes and larger claimed damages in class action cases.

With respect to substantive liability, it is also readily apparent that in adopting Sarbanes, Congress intended to clarify the existing responsibilities of public companies and their directors and officers and to impose upon them additional corporate governance obligations. With respect to resulting causes of action, Section 3 of Sarbanes uses broad language in providing that a violation of Sarbanes, any rule or regulation of the SEC under Sarbanes, or any rule of the Public Company Accounting Oversight Board will be treated

[1]It is equally clear that the risk to professionals performing services to public companies, such as accountants, investment bankers and lawyers has increased, but the focus of this article is limited to issuers and their directors and management.

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for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (14 U.S.C. § 78a et. seq.) (the "Exchange Act") or the rules and regulations thereunder, consistent with the provisions of Sarbanes. Any person who commits a violation will be subject to the same penalties, and to the same extent, as for a violation of the Exchange Act or such rules and regulations. There is no distinction made in Section 3 between the claims of private litigants and actions instituted by regulators and, with limited exception, this distinction is not made in the substantive provisions of the legislation that create civil liability for an issuer or its directors and officers. In fact, in Titles II, III and IV of the act, which impose the majority of the new corporate governance obligations, only one section, Section 303, limits enforcement authority to the SEC. Because Congress added this express limitation to Section 303, but did not do so in other sections of these Titles, plaintiffs will certainly argue that virtually every violation of their provisions gives rise to a private cause of action.

Increased Exposure to Liability for Management. A central theme of Sarbanes is the creation of more transparency, more structure and more accountability in the financial reporting and disclosure processes used by public companies. Consequently, the law imposes new disclosure requirements; tightens and clarifies requirements regarding the adequacy of internal controls and the completeness and accuracy of disclosures; and requires that senior management publicly certify compliance with these requirements. The additional disclosure requirements obviously provide new opportunities for plaintiffs to assert that certain required disclosures are missing or that they are misleading. Given the complexity of some of the new disclosure requirements, this will likely be a fertile area for the creation of "new" 10b-5 claims. For example, the SEC rules implementing Section 401 of Sarbanes require disclosure regarding off-balance sheet arrangements and contingent liabilities that, arguably, was not required prior to Sarbanes. Plaintiffs will now look at a whole host of off-balance sheet items (e.g., special purpose entities or lease obligations) as being required disclosure. While these are not necessarily new causes of action, they are "new" in the sense that liability may now arise from acts and omissions that were not actionable prior to Sarbanes.

The certification requirements of the act are certain to be the focus of litigation. Under Section 302, CEOs and CFOs are now required to certify in each periodic report filed with the SEC that:

(I) they have read the report;

(ii) to their knowledge, the report does not contain an untrue statement of material fact or omit a material fact, and the financial information therein fairly presents in all material respects the financial condition and results of operations of the company;

(iii) they are responsible for establishing and maintaining internal controls,[2] have designed such controls to ensure material information is made known to them, have evaluated those controls as of a recent date and have reported their conclusions about their effectiveness in the filing;

(iv) they have disclosed significant deficiencies in, material weaknesses in, and fraud in

[2]The SEC's rules under Section 302, some of which are still in proposed form, bifurcate the concept of internal controls into "disclosure controls and procedures," which are designed to ensure accurate and timely reporting of information in a company's periodic reports, and "internal controls and procedures for financial reporting." A new, proposed form of certification, which will presumably be required for a company's first annual report on Form 10-K filed after September 15, 2003, will apply the certification requirements described in items (iii), (iv) and (v) to both types of controls. *See* Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-46701 *available at* http://www.sec.gov/rules/proposed/33-8138.htm (Oct. 22, 2002), and Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46427 *available at* http://www.sec.gov/rules/final/33-8124.htm (Aug. 29, 2002). *See also* note 3, *infra*.

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connection with those controls to the audit committee and the external auditors; and

(v) they have indicated in the report any significant changes in internal controls since their evaluation.

On a first look, this certification does not seem to require much more than was previously expected of these officers in connection with signing the reports themselves. Before Sarbanes, they should have read the report, made sure procedures were in place to ensure they were aware of material information and that the report was accurate, and reported any problems in those processes to the audit committee and auditors so they could be properly addressed. However, in the context of litigation, the certification could be significant. Before the Sarbanes requirement, these senior officers could (and did) argue that even though they signed an inaccurate report, they did not act with the requisite scienter to give rise to liability for securities fraud. Although scienter is certainly still the liability standard, by signing the required certification it will now be more difficult for a defendant CEO or CFO to argue "lack of knowledge" in certain respects. Arguably, the certification limits their ability to defend a claim based upon their lack of knowledge regarding internal controls. They will have certified that they put in place an internal control process designed to ensure that they did obtain the "material information," and that they have evaluated the effectiveness of the controls. Even the items in the certification that are limited by knowledge must be viewed in the context of the heightened process and review requirements of the other portions of the certification, implicitly creating a higher threshold of knowledge.

Moreover, it seems that the certification itself could give rise to a claim under Rule 10b-5. In the past, if a CEO did not read a report, or failed to evaluate the internal control system and was unaware of a weakness that led to financial inaccuracies, the CEO might argue that the element of scienter was lacking. However, with the certification that the CEO has read the report and evaluated the control system, the failure to have done this would seemingly give rise to a fraud claim based upon the statement *in the certification*. The claim would be premised upon the CEO's materially misleading "assurance" to the public in the form of the certification.

Similarly, the new requirement that management include an internal control report in the company's annual report on Form 10-K might be used as the basis of new theories of liability.[3] The report must state management's responsibilities for establishing and maintaining adequate controls and contain an assessment of the effectiveness of those controls as of the end of the year. If the controls fail after this assurance from management regarding their effectiveness, plaintiffs can be expected to argue that the report gives rise to fraud liability and constitutes a material misstatement with respect to the effectiveness of the controls.

In addition to increased antifraud liability, company officers face two other specific pitfalls under Sarbanes. First, under Section 304 of Sarbanes, if the company restates its financials due to "material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO and CFO must reimburse the company for any bonus, incentive-based or equity-based compensation, or profits from the sale of company securities received in the twelve months starting with the first public issuance of the noncompliant financials. Consequently, CEOs and CFOs may confront claims that characterize any restatement of financial statements as resulting from misconduct in order to seek the additional disgorgement by these officers. In cases where restatements have not occurred, plaintiffs may try to press claims that a restatement should occur, giving rise to these additional remedies directed at senior management. Like Section 3 of the act, Section 304 is silent on how this remedy is to be enforced,

[3]This requirement, which arises under Section 404 of Sarbanes, requires SEC rulemaking for implementation, but, unlike other sections of the act, does not contain a deadline for final rules. As of the date of this article, the SEC's rules relating to this section are still in proposed format, and consequently the discussion reflects those proposed rules. *See supra*, note 2.

leaving open the possibility for shareholder derivative action.

Second, under Section 306 of Sarbanes, any officer or director who trades during a pension fund blackout period[4] in company stock acquired in connection with his or her employment with or service to the company must disgorge the profits of such trading. As with current liability under Section 16 of the Exchange Act, no scienter is required with respect to these trades. In addition, unlike many of the other provisions of Sarbanes, derivative suits are specifically permitted by Section 306 if the company does not act within a certain time frame.

Increased Exposure to Liability for the Board of Directors. Increased exposure under Sarbanes is not limited to members of management. The act also clearly specifies certain obligations of directors and, arguably, increases the scope of directors' obligations. The most prominent examples are found in the provisions related to the conduct of the audit committee of the board of directors. Section 301 of Sarbanes states that the audit committee is "directly responsible for the appointment, compensation and oversight" of the company's external auditor. Section 301 includes in this responsibility the "resolution of disagreements between management and the auditor regarding financial reporting." This requirement is combined with Section 204's mandate that the auditors report to the audit committee all critical accounting policies used; alternative treatments of financial information discussed with management, including their ramifications and the auditors' preferred treatment; and any material written communications with management. It is not difficult to imagine that plaintiffs will use these provisions, in combination with other sections of the act, to assert that audit committee members are ultimately responsible for the accuracy of the company's financial statements, effectively "insuring" the representations of management and the quality of the work of the auditors.

While such an assertion would seem to be extreme, Sarbanes may give credence to such a theory of liability. The CEO and CFO certify in each periodic report that they are notifying the audit committee of deficiencies and weaknesses in the internal control system. It is a short step for a plaintiff to claim that the audit committee has ultimate responsibility to take measures to ensure that those deficiencies and weaknesses are corrected. At the same time, auditors are providing the required Section 204 disclosure regarding critical accounting policies to the audit committee. When the committee members sign a Form 10-K,[5] their heightened knowledge and responsibility similarly reduces their ability to claim that they were unaware of any violations of Rule 10b-5. Given the committee's express "oversight" responsibility for the company's auditor, plaintiffs may argue that the audit committee members, by signing the report, are giving investors a "heightened" assurance that the auditor's work is proper and that the financial statements are accurate.

The Studies: The Prospect of More Sarbanes-Related Exposure. Not only do Sarbanes and the SEC rules implementing it create opportunities for expanded liability, but the studies required under the act also imply that more is yet to come. For issuers, management and boards of directors, the studies mandated by Sections 308(c), 401(c) and 704 indicate that additional disclosure requirements and greater penalties may soon be addressed. And for secondary actors such as auditors, investment banks, lawyers and others, the study required by Section 703 signifies that Congress may be contemplating legislation installing aiding and abetting liability for secondary actors. The Supreme Court left this avenue open to Congress when it forestalled such liability under current regulations in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Each of these studies, as well as the many opportunities provided elsewhere in the act, portend an increase in sources of liability and litigation in the hands of the plaintiffs' bar.

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[4]Defined as three or more consecutive business days in which 50% or more of the participants in the pension fund cannot trade in company securities in the fund.

[5]Pursuant to General Instruction D of Form 10-K, the majority of the board of directors is required to sign the form.

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