THE ROLE OF AUDIT COMMITTEES IN THE WAKE OF CORPORATE FEDERALISM: SARBANES-OXLEY'S CREEP INTO STATE CORPORATE LAW

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The passage of the Sarbanes-Oxley Act of 2002[1] (the "Act") brought about one of the most sweeping reforms since the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 during the New Deal administration.[2] Sarbanes-Oxley departed from the existing disclosure-based model of regulation and empowered the Securities and Exchange Commission to enter the arena of corporate governance, which had been largely left to the states to regulate.[3] Particularly with respect to audit committees, the Act and rules promulgated thereunder have imposed fiduciary-type obligations that have created an adversarial corporate governance structure. This dynamic has been compounded by current trends in state law jurisprudence in the courts' more rigorous application of state fiduciary duties in an attempt to forestall further preemption resulting from the Act and the rules promulgated thereunder. Taken together, these developments will likely lead to a decline in the overall competitiveness of U.S. capital markets.

Part I of this article will address relevant history and the evolution of the Commission's involvement in audit committee governance. Part II will address the enactment of the Act and its affect on the composition and conduct of audit committees. Part III will address fiduciary duties under Delaware law[4] and the effects the Act has had on that state courts' application of

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[1] 15 U.S.C. § 7201 (2002).

[2] Renee Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, B.C. PUB. L. & LEGAL THEORY RESEARCH PAPER SERIES 629 (2004).

[3] *Id.*

[4] Delaware is the state of incorporation for more than half of U.S. public companies, so the analysis will focus on Delaware law.

its corporate law. Part IV will seek to predict the effects of the Act and the resulting trends in corporate law.

I. RELEVANT HISTORY PRIOR TO SARBANES-OXLEY

The SEC first became concerned with the quality of public company audits in 1940 in conjunction with its investigation of *McKesson and Robbins*.[5] Prior to the enactment of the Sarbanes-Oxley Act the Commission primarily engaged in cajoling as its means of regulating the composition and conduct of audit committees. In *McKesson*, an audit by Price Waterhouse did not detect the siphoning of millions in cash by members of the company's senior management.[6] The executive officers overstated the company's inventory and accounts receivable by approximately $20,000,000 and reported large profits from a fictitious drug business.[7] The SEC concluded that, while Price Waterhouse applied generally accepted accounting principles, those principles were insufficient to detect such fraud.[8] The Commission suggested that public companies should "establish . . . committee[s] to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement."[9]

During the 1970's, audit failures again came to the forefront as a result of questionable corporate payments and the criminal conviction of an accounting firm in connection with financial fraud.[10] In 1973, the investigation of the Watergate break-in alerted the Securities and Exchange Commission to the use of corporate funds for illegal political contributions.[11] The SEC conducted a probe that revealed widespread episodes of unreported illegal or suspect corporate payments, both foreign and domestic.[12] As a result, the SEC began promulgating corporate disclosure requirements that established standards of corporate governance in an indirect fashion on two fronts.[13]

First, the SEC encouraged Congress to enact legislation "aimed expressly at enhancing the accuracy of corporate reporting of books and records and the reliability of the audit process."[14] In 1977, Congress enacted the Foreign Corrupt Practices Act ("FCPA"), which codified the existing accounting control provisions set forth in auditing standard No. 1.[15]

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[5] LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 716 (3d ed. 2004).
[6] Summary of findings and conclusions in the matter of McKesson & Robbins, Inc., Accounting Series Release No. 19,.Exchange Act release No. 2,707 (Dec. 5, 1940).
[7] *Id*. at 3.
[8] *Id*. at 7.
[9] *Id* at 4.
[10] LOSS & SELIGMAN, *supra* note 5, at 718-20.
[11] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8,238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068 (June 18, 2003).
[12] SEC Report on Questionable Illegal Payments and Practices, submitted to Senate Banking, Housing and Urban Affairs Committee, 94th Cong. 2d Sess. (May 12, 1976), *see* Sec. Act Release No. 8,238.
[13] ARTHUR H. BILL, AUDIT COMMITTEE GUIDE, at 3 (Bowne & Co. 3d. ed., Feb. 2006).
[14] SEC Report on Questionable Illegal Payments and Practices, *supra* note 12. *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *supra* note 11.
[15] *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *supra* note 11.

Generally, the FCPA has two primary components. The first prohibits corrupt practices in connection with domestic companies securing an improper advantage by making payments to foreign government officials.[16] The second component requires reporting companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with [GAAP]".[17]

The FCPA had a more profound effect on the company's management and independent public accountants than on the audit committees, as audit committees in general had a lesser role relating to the auditing matters. The primary purpose of this section, as stated in legislative history, was "to operate in tandem with … the provision in the FCPA to deter corporate bribery."[18] The section has also been used by the SEC in connection with the enforcement of deficiencies in books and records as well as internal controls.[19]

Secondly, in 1977, in a circuitous effort to establish corporate governance standards, the SEC Chairman Roderick Hills requested and the Commission subsequently approved a new listing standard for NYSE, requiring that listed companies have "audit committee[s] composed solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member."[20] While this step appeared significant, an estimated 90% of the country's largest companies already had audit committees prior to the new requirements.[21] Soon thereafter the American Stock Exchange and National Association of Securities Dealers Automated Quotations (NASDAQ) adopted similar provisions.[22]

In 1978, the SEC adopted rules requiring disclosure, in a reporting company's proxy statement, as to whether it had audit, nominating and standing committees.[23] The SEC conducted a survey of 1,200 publicly traded companies and discovered that the typical audit committee met 2.7 times per year and limited its functions to approval of the selection of the company's auditors and review of the audit plans and results.[24] During that same period, the SEC increasingly settled enforcement actions in which the companies agreed to the organization of audit committees to direct the financial reporting process.[25]

"In 1985, in the wake of another series of major audit failures, extensive hearings were held by the House Committee on Energy and Oversight on the SEC and Corporate Audits."[26] As a result, in 1987 the AICPA established a private sector initiative, known as the National

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[16] FRANK M. BURKE & DAN M. GUY, AUDIT COMMITTEE GUIDE: A GUIDE FOR DIRECTORS, MANAGEMENT, AND CONSULTANTS 12 (2005).
[17] *Id.*
[18] S. Rep. No. 95-114, at 7 (1977).
[19] *See* BURKE & GUY, *supra* note 16, at 12.
[20] LOSS & SELIGMAN, *supra* note 5 at 722; Exchange Act Release No. 13,346, 11 SEC Dock. 1945 (1977).
[21] Roderick Hills, Chairman, SEC, Address at the Am. Enter. Inst., Mayflower Hotel, D.C. (June 21, 1976); *see also* LOSS & SELIGMAN, *supra* note 5, at 716.
[22] LOSS & SELIGMAN, *supra* note 5, at 716.
[23] Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Sec. Exch. Act Release No. 15,384, Investment Company Act Release No. 10,510 (Dec. 6, 1978).
[24] *See* LOSS & SELIGMAN, *supra* note 5, at 723; *see generally*, SEC, Staff Report on Corporate Accountability: A Re-Examination of the Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance, 96th Cong. 2d Sess. 496-506, 608 (1980).
[25] BILL, *supra* note 13.
[26] *See* LOSS & SELIGMAN, *supra* note 5, at 724.

Commission on Fraudulent Financial Practices, to identify the factors that permit fraud and to recommend methods for prevention.[27] The Committee was led by former SEC Chief James Treadway.[28] As part of its recommendation, the Treadway Commission proposed that the boards of directors of all public companies be required to have independent audit committees and, upon changing auditors, listed companies be required to disclose any material disagreements. [29]

The Treadway Commission specifically recognized the audit committee as a crucial gatekeeper in the deterrence and discovery of fraudulent activity.[30] The Treadway Commission's final report recommended that:

> (1) all public companies be required to have an audit committee composed entirely of independent directors; (2) additional public disclosure [be required] in the event of a change in the independent public accountants; (3) Congress should give the SEC additional enforcement tools so that it can impose fines, begin cease and desist proceedings, and bar or suspend individual perpetrators from serving as corporate officers or directors; and (4) public accounting firms that audit public companies must belong to a professional organization that has peer review and independent oversight functions and is approved by the SEC.[31]

Surprisingly, no official action was taken with respect to the recommendation, although a portion of these recommendations were reemphasized in 1999 by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Committees.[32]

In 1994, the Public Oversight Board of the SEC Practice Section of the AICPA established an advisory panel on Auditor Independence to research methods to "bring auditing into the mainstream of corporate governance and to restore auditing to its important role in our society."[33] Their report, entitled "Strengthening the Professionalism of the Independent Auditor," suggested that each audit committee should be informed as to the appropriateness of the company's application of the accounting principles and the degree of conservatism or aggressiveness in the application of such principles. [34]

In 1995, the Private Securities Litigation Reform Act was enacted in an effort to curb abusive class action litigation.[35] The Act added Section 10A to the Securities Exchange Act, requiring that each reporting company's audit include procedures for the discovery of illegal acts and related party transactions, and the evaluation of the going concern status of the company.[36] In addition, the section codified Generally Accepted Auditing Standards in

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[27] BILL, *supra* note 13.

[28] *Id.*

[29] Report on National Commission on Fraudulent Financial Reporting 40 (Oct. 1987). The commission was sponsored by the AICPA, Am. Accounting Ass'n, Fin. Exec. Int'l, Inst. of Internal Auditors, and Inst. of Mgmt. Accountants.

[30] *Id.*

[31] *Id.* at 12-14.

[32] *See* BURKE & GUY, *supra* note 16, at 25.

[33] BILL, *supra* note 13, at 4.

[34] *Id.*

[35] PL 104-67 (1995).

[36] BILL, *supra* note 13.

connection with detection of fraudulent acts by issuers and imposed expanded obligations on auditors to report, in a timely fashion, information regarding such acts.[37]

In 1998 in a speech entitled *The Numbers Game*, then SEC Chairman Arthur Levitt stressed that an independent audit committee is vital to protecting the integrity of the public reporting process, and expressed concerns about selective disclosure and earnings management.[38] During his speech he criticized the members of the financial community and corporate America by stating that, "Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In a zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."[39] In his concluding remarks, he reminded auditors that they are the public's watchdog and we rely on them to "put the good housekeeping seal of approval on the information that investors receive," and stated that "qualified committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest."[40]

Prior to Sarbanes-Oxley, the SEC had limited ability to affect corporate governance matters.[41] The Commission was limited to requiring the disclosure of the existence and activities of such committees.[42] Conversely, the stock exchanges and self-regulatory organizations had the ability to mandate corporate governance standards as a condition of being listed.[43]

In 1998, at the request of Chairman Levitt, National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) sponsored the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, composed of leading representatives of the accounting and legal professions, as well as the investment and business communities.[44] The Committee issued its report in 1999, which asserted that an independent audit committee is "an effective corporate governance vehicle for assuring high-quality financial reporting."[45] In order to strengthen audit committee independence, effectiveness, and accountability the Committee made recommendations for both the exchanges and the SEC.[46]

The NYSE and the NASD were urged to:

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[37] *Id.* Section 10A states that if an independent public accountant "detects or otherwise becomes aware of information indicating that an illegal act … has or may have occurred" (whether or not material), the accountant must inform the appropriate level of management of the issuer and ensure that the audit committee or the board is adequately informed with respect to the illegal acts. Failure to respond to a material act will require the accountant to report its conclusions to the board or resign or furnish the commission a copy of its report.

[38] Arthur Levitt, Chairman, SEC, Remarks at NYU Ctr. for L. & Bus: *The Numbers Game*, (Sept. 28, 2006) (transcript available at www.sec.gov/news/speech/speecharchive/1998/spch220.txt). Earnings management is the process by which management will charge extra expenses in a period of strong financial results in order save the income for a period when earning are not up to analysts expectation or conversely recognize income prematurely to meet analyst expectation.

[39] *Id.*

[40] *Id.* at 6-7.

[41] HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE §3.1, (2005-06 ed., 2005).

[42] *Id.*

[43] BURKE & GUY, *supra* note 16, at 4.

[44] *Id.* at 4-5.

[45] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1067, 1072-74 (1998-99.)

[46] *Id.* at 1072; BILL, *supra* note 13, at 89-90.

> (1) Adopt a specific definition of independence for audit committee members;[47] (2) require that listed companies assemble audit committees with a minimum of three members, all of whom are independent and financially literate and at least one of whom has financial management expertise;[48] and (3) require that all audit committees adopt a formal written charter that is approved by the board and reviewed annually, specifies that the auditor is ultimately accountable to the audit committee, and gives the audit committee responsibility for monitoring the relationships between the auditor and the company, so as to ensure independence.[49]

It was recommended that the SEC should:

> (1) Require each audit committee to disclose in the proxy statement whether it has adopted a charter and if the committee is in compliance, and to include a letter from the committee in the company's annual report confirming that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP);[50] and (2) require that a company's outside auditor conduct an Interim Financial Review and discuss any critical accounting issues with the audit committee prior to the filing of each Form 10-Q.[51]

The Blue Ribbon Committee also suggested that Generally Accepted Auditing Standards (GAAS) be revised to require that a company's outside auditor discuss his/her judgments about the quality and level of aggressiveness of the company's accounting principles with the audit committee.[52]

In December 1999, the SEC adopted final rules implementing most of the Committee's recommendations, requiring that the companies' independent auditors review their companies' financial information prior to releasing financial results, and that companies include in their proxy statements certain disclosures about their audit committees and reports from their audit committees and contain certain disclosures as to whether the Board of Directors had adopted an audit committee charter, and whether the audit committee is solely composed of independent members and, if not, disclosure of the nature of the relationship which renders the director(s) not independent.[53]

In response to the recommendation of the Blue Ribbon Committee, NASAQ and NYSE amended their corporate governance rules with respect to audit committees, requiring listed companies to have written audit committee charters, and requiring such committees to be independent under their respective definitions.[54]

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[47] *Id.* at 1073; BILL, *supra* note 13, at 90.
[48] *Id.* at 1074-75; BILL, *supra* note 13, at 91-92.
[49] *Id.* at 1073-75; BILL, *supra* note 13, at 91-92.
[50] Blue Ribbon, *supra* note 45, at 1074-75; BILL, *supra* note 13, at 91-92.
[51] *Id.* at 1075-76; BILL, *supra* note 13, at 91-92.
[52] *Id.* at 1075; BILL, *supra* note 13, at 92.
[53] 17 C.F.R. § 228.306 (Repealed 2006).
[54] *See* BILL, *supra* note 13, at 6.

NASDAQ and NYSE Audit Committee Listing Requirements

Stock exchange listing requirements, which are typically embodied in a written contract between the issuer and the exchange, have predated both Sarbanes-Oxley and the Securities and Exchange Acts.[55] While initially only enforceable as a matter of contract law, these agreements required listed companies to conduct annual meetings and distribute annual reports to shareholders.[56]

Under NYSE's listing requirements, each listed company is required to have an audit committee composed of a minimum of three members who are financially literate and are independent.[57] For purposes of independence, the NYSE rule states "No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."[58]

NASDAQ also requires a listed company's audit committee to have a minimum of three members on its audit committee and be comprised only of independent directors who have not participated in the preparation of the financial statements of the company or any subsidiary during the past three years and who are able to read and understand financial statements, including balance sheets, income statements and statements of cash flows.[59] NASDAQ defines an independent director as "a person other than an executive officer or employee of the company . . . or any other individual having a relationship which, in the opinion of the

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[55] Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL J. CORP. L. 79, 92 (2005).

[56] *Special Study on Market Structures, Listing Standards, and Corporate Governance*, 57 BUS. LAW. 1487, 1498 (2001-02); Karmel, *supra* note 55, at 92.
Since the Act directs the Commission to require all national securities exchanges and NASDAQ to adopt standards with respect to the composition, independence, and authority of audit committees, a violation of a provision of a listing agreement relating to these standards could result in an SEC enforcement action.

[57] NYSE, Inc., LISTED COMPANY MANUAL, 303A.07 (2007).

[58] *Id.* at 303A.02. NYSE deems directors not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company. (ii) The director has received, or has an immediate family member who has received, during any twelve-month period in the last three years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service. (iii) (a) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (b) the director is a current employee of such a firm; (c) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (d) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time. (iv) The director or an immediate family member has, within the last three years, been an executive officer of another company where any of the listed company's present executive officers concurrently served on that company's compensation committee. (v) The director is a current employee, or an immediate family member is a current executive officer of a company that has made payments to, or received payments from, the listed company in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

[59] NASDAQ, Inc., Rule 4350(d).

issuer's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[60]

Section 301 of the Act, which amended Section 10A of the Securities and Exchange Act, required the Commission by rule to "direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of" the rules relating to the composition, independence and authority of audit committees.[61] However, these provisions are duplicative and less rigorous than what NYSE and NASDAQ had previously required as a condition of listing prior to the Act.[62]

II. THE SARBANES-OXLEY ACT OF 2002

The demise of numerous large corporations in 2001-2002 dealt a severe blow to the American capital markets, decimating investor confidence.[63] Scandals of mismanagement and corruption at Tyco, Enron, Adelphia and others caused massive losses for investors ranging from pension funds to rank and file employees.[64] "The aftermath of these scandals not only resulted in widespread asset devaluation, but also called into question the adequacy of the federal securities laws that were designed to ensure that public companies provide investors with full and accurate disclosure of their true financial conditions."[65]

In response, Congress passed the Sarbanes-Oxley Act of 2002.[66] It was designed "[t]o protect investors by improving the accuracy and reliability of corporate disclosures."[67] In its

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[60] NASDAQ, Inc., Rule 4200(a)(15).

> NASDAQ considers the following persons not to be independent: (a) a director who is, or at any time during the past three years was, employed by the company or any parent or subsidiary of the company; (b) a director who accepted or who has a family member who accepted any compensation from the company in excess of $60,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than (i) compensation for board or board committee service; (ii) compensation paid to a Family Member who is an employee (other than an executive officer of the company); or (iii) benefits under a tax-qualified retirement plan , or non-discretionary compensation; (c) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company as an executive officer; (d) a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made or received payments in the past three fiscal years that exceeded 5% of the recipient's revenues, or $200,000, whichever is more; (e) a director who is, or has a Family Member who is, employed as an executive officer of another entity where at any time in the past three years any of the executive officers of the issuer serve on the compensation committee of such other entity; or (f) a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years. On November 15, 2006, NASDAQ filed a rule change with the SEC that would increase the direct payment test under the definition of Independent Director in NASDAQ Rule 4200(a)(15) from $60,000 to $120,000 in order to be consistent with Item 404 of Regulation S-K.

[61] Sarbanes-Oxley Act, *supra* note 1, at § 301.

[62] BLOOMENTHAL, *supra* note 41, at § 3:1.

[63] Marilyn B. Cane & Peter Ferola, *Back to the Future: The States' Struggle to Re-Emerge as Defenders of Investors' Rights*, 5 U.C. DAVIS BUS. L.J. 15 (2005) (available online at http://blj.ucdavis.edu/article/553).

[64] *Id.*

[65] *Id.*

[66] Sarbanes-Oxley Act, *supra* note 1.

first significant step into federalizing state corporate law, Congress empowered the SEC to direct the national stock exchanges and NASDAQ to require all listed companies to establish an audit committee as well as dictate the composition and conduct of the committee.[68] The Act also requires that the audit committee of each issuer be responsible for all matters related to the audit engagement,[69] and that audit committee members be independent, as defined under the rules promulgated under the Act.[70] Audit committees are also required to establish a procedure for the receipt of accounting-related complaints and have the authority to engage advisers.[71]

Standards Relating to Audit Committees

On April 25, 2003, the Commission's rule implementing the new audit committee standards became effective.[72] Under Exchange Act Rule 10A-3, national securities exchanges and national securities associations are "to prohibit the initial or continued listing of any security" not in compliance with the independence standard or whose directors are not empowered to carry out their duties as directed by section 10A(m) of the Act.[73] Generally, the rule provides that in order to maintain their listings, a reporting company must have an audit committee that is comprised of independent directors; is directly responsible for the appointment of and matters related to the audit, including mediating disputes between management and the auditors; establishes procedures for the receipt of complaints; and has the authority to engage advisors.[74]

Independence

In its final rules the Commission prescribed that all audit committee members must be on the board of directors and be independent.[75] An audit committee member is deemed independent if such member is not an affiliated person of the issuer or any subsidiary, other than through his or her role as a director or member of the audit committee or other board committee.[76] In addition, to meet such independence criteria, an audit committee member "may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee . . . accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof."[77]

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[67] *Id.*
[68] *Id.* *See* BLOOMENTHAL, *supra* note 41.
[69] 15 U.S.C. § 78j-1(m)(2) (Supp. 2004).
[70] *Id.* at § 78j-1(m)(3).
[71] *Id.* at (m)(4).
[72] Standards Relating to Listed Co. Audit Comms., Sec. Act Release No. 8,220, Exch. Act Release No. 47,654, Inv. Co. Act Release No. 26,001, 79 SEC Dock. 2,876 (Apr. 9, 2003), 2003 WL 1833875 at *1.
[73] 17 C.F.R. § 240.10A-3(a) (2006).
[74] *Id.* at (b).
[75] *Id.* at (b)(1)(i).
[76] BLOOMENTHAL, *supra* note 41. The term affiliate of, or a person affiliated with, a specified person means a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is in common control with the person specified.
[77] 17 C.F.R. § 240.10A-3 (2006)

> If not precluded by any rule promulgated by an exchange or SRO, an audit committee member can also receive a fixed amount of compensation for prior services rendered so long as such compensation is not

Responsibility Relating to Public Accounting Firms

The Commission also established standards of conduct for audit committee members by requiring the audit committee of each reporting company to "be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) . . . and each such registered public accounting firm must report directly to the audit committee." [78]

With the exception of minor substitutions, the Commission adopted the statutory language virtually word for word.[79] The Commission left it to the exchanges and SROs to stipulate any details they considered necessary.[80] The rule was adopted with the intent of aligning the auditors' interest with that of the shareholders.[81] In its adopting release, the Commission stated that "[t]he auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee" and may result in the auditor not having appropriate incentive to raise concerns and conduct an objective examination of the financial statements.[82] In addition to oversight responsibilities set forth above, the audit committee has ultimate authority to approve all audit fees.[83]

Complaints

The Commission further regulated the conduct of audit committees by requiring them to establish procedures for the "receipt, retention, and treatment of complaints . . . regarding accounting, internal accounting controls, or auditing matters."[84] In addition committees are required to establish procedures that maintain confidentiality and anonymity of all complaints received in connection with "questionable accounting or auditing matters."[85] In its adopting release the Commission stated, "[T]he establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences."[86] In adopting the final rule the Commission did not mandate any specific

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contingent on future services. Through the mechanism of defining indirect compensation, an audit committee member is deemed to have received a prohibited form of compensation as a result of (1) compensation received by certain family members and (2) compensation by certain types of entities with which the director is associated in certain designated capacities. The latter relates to entities such as investment banking, legal and consulting firms that receive compensation. To the extent that the audit committee member has a limited role such as non-managing member, limited partner or similar role with no active role in providing such services, then the receipt of such compensation will not impair the committee member's independence. BLOOMENTHAL, *supra* note 41.

[78] 17 C.F.R. § 240.10(A)(3)(b-2) (2006).

[79] BLOOMENTHAL, *supra* note 41, at §3.4.

[80] *Id.*

[81] Sec. Act Release No. 8,220, *supra* note 72.

[82] *Id.*

[83] 17 C.F.R. § 240.10(A)(3)(b-5) (2006).

[84] *Id.* at (A)(3).

[85] *Id.*

[86] Sec. Act Release No. 8,220, *supra* note 72.

procedure that must be established; this is one the few areas of the Act in which reporting companies are provided with flexibility to tailor a procedure that would be most effective.[87]

Authority to Engage Advisers

While the Commission has created additional responsibilities by promulgation of these new standards of conduct, it has attempted to ensure that the each audit committee is adequately equipped to handle such tasks by requiring it to have the "authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties."[88] Under most circumstances, an audit committee is not qualified to self advise on all legal, finance and accounting matters.[89] Consequently, there may be instances where the committee would need to engage the services of accounting or legal advisors apart from those who have been hired by management, especially when a potential conflict of interest exists.[90] Additionally, the assistance of outside advisors may be required to independently investigate questions that have arisen in connection with financial reporting, securities laws compliance, and integrity of management in connection with the discharge of their duties.[91] In such circumstances, outside advisers can determine the best practices of other similarly situated companies that might be suitable for the issuer.[92] This rule enables an audit committee to obtain the resources necessary to be effective.

Funding

In further effort to ensure that audit committees are well-equipped to render effective oversight, each reporting company "must provide for appropriate funding, as determined by the audit committee … [in order to compensate the] registered public accounting firm, …any advisers employed, …and ordinary administrative expenses." [93]

This rule is designed to ensure the committee's effectiveness by obviating the need for management to approve compensation for the company's independent auditor or the other advisors engaged by the committee.[94] The rationale behind this rule is that, absent such a provision, advisors might be less willing to address disputes with management, as they would be reliant on management to determine their compensation and the future course of the relationship.[95]

Flaws in the System

Roberta Karmel, a former SEC Commissioner, has suggested that, taken as a whole, revised Section 10(A) undermines the well-established state law principles that a corporation's board of directors is responsible for the overall management and supervision of

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[87] *Id.*
[88] 17 C.F.R. § 240.10, *supra* note 83.
[89] Sec. Act Release No. 8,220, *supra* note 72.
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] 17 C.F.R. § 240.10(A)(3), *supra* note 83.
[94] Sec. Act Release No. 8,220, *supra* note 72.
[95] *Id.*

its affairs.[96] In her view, the audit committee has become a "super committee" with respect to audit-related matters and the "financial expert" has become a "super committee member."[97]

A key component of the Commission's corporate governance policy centers around the independent director.[98] According to Karmel, the new responsibilities placed on audit committee members is akin to asking a part-time employee to perform a full-time job, while maintaining his or her objectivity.[99] Karmel has asserted that "these rules undercut the long-standing principle of state law that the entire board of directors is responsible for directing the management and supervising the affairs of a corporation."[100] If audit committee members "spend all of their time auditing the auditors … they will have no time to focus on important business and strategy matters."[101] She also suggests that with the increased responsibilities put on audit committee members, they will in essence become "full-time" directors and thus, lose their objectivity.[102]

III. ENCROACHMENT ON DELAWARE LAW

The passage of the Act departed from the disclosure-based model and took the first significant step into corporate governance by prescribing standards as well as prohibiting certain conduct.[103] This resulted in the federalization of existing Delaware corporate law, specifically with respect to executive loans, composition and responsibilities of audit committees, and the definition of independence.[104]

With respect to audit committees, Delaware corporate law states that "The board of directors may … designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation."[105] With the exception of limited circumstances, Delaware law also grants broad authority to committees of the board of directors to "exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation."[106] However, the Act now requires that the audit committee of each issuer be directly responsible for all matters related to the appointment, compensation and oversight of the registered public accounting firm, as well as mediate any disagreements between

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96 Karmel, *supra* note 55.
97 *Id.*
98 *Id.*
99 *Id.* at 134.
100 *Id.* at 111.
101 Karmel, *supra* note 55, at 111.
102 *Id.*
103 Jones, *supra* note 2, at 642.
104 *Id.* Under Delaware corporate law, any corporation may "any may lend money to, or guarantee any obligation of, or otherwise assist any officer or other employee of the corporation …whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation." DEL. CODE ANN. tit. 8, §143. The Delaware statute defers to the board judgment in that corporate loans may be made "with or without interest, and may be unsecured, or secured in such manner as the board of directors shall approve" including, without limitation, a pledge of shares of stock of the corporation. Conversely, the Act expressly forbids any issuer to "directly or indirectly … to extend or maintain credit, to arrange for the extension of credit … in the form of a personal loan to or for any director or executive officers. *Id.*
105 DEL. CODE ANN. tit.8, § 141.
106 *Id.* Delaware law expressly prohibits committees from approving or adopting, or recommending to the stockholders, any action or matter (other than the election or removal of directors) or otherwise required to be submitted to stockholders for approval or adopting, amending or repealing any bylaw of the corporation.

management and the accountants.[107] In addition, the Act by definition requires that audit committee members be independent.[108] In implementing this requirement the Commission has labored to create an extensive definition of independence. Dissimilarly, Delaware common law has held that "independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[109]

Sarbanes-Oxley Act's Effect on Delaware Corporate Law

The enactment of the Sarbanes-Oxley Act has created fiduciary-type obligations affecting audit committees not currently imposed by Delaware corporate law, as well as affected the way Delaware courts are applying existing law to cases involving breaches of fiduciary duties.

Under traditional norms of corporate governance embodied in Delaware law, corporate affairs are managed by the board of directors through its executive officers.[110] To deter management misconduct and to provide shareholders a remedy for skirting or stealing, the law imposes on management the fiduciary duties of care, loyalty and good faith.[111]

Duty of Care

The duty of care "imposes upon directors an affirmative duty to use reasonable care under the circumstances in making corporate decisions."[112] In particular, a director must "discharge duties in good faith, in a manner he reasonably believes to be in the best interest of the corporation,"[113] and he/she must become informed in performing "decision-making and oversight functions with the care a person in a similar position would reasonably believe appropriate under the circumstances."[114] In order to recognize the scope of the duty of care, one must understand the business judgment rule. Under this rule the courts apply a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company."[115] Where such standards apply courts have been reluctant to second-guess directors' business decisions.[116] Under Delaware law, a director will not be found individually liable, and the board collectively liable, solely for failing to inform themselves fully and deliberately before voting on a particular matter.[117]

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[107] 15 U.S.C. § 78j-1(m)2 (2006).
[108] *Id*. at § 78j-1(m)3.
[109] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[110] Jones, *supra* note 2, at 646.
[111] *Id.*
[112] Dana M. Muir & Cindi A. Schipani, *The Challenge of Company Stock Transactions for Directors Duty of Loyalty*, HARV. J. ON LEGIS., 437, 440 (Summer 2006).
[113] Model Bus. Corp. Act § 8.30(a)-(b) (Supp. 2002).
[114] *Id.*
[115] *Aronson*, 473 A.2d at 812; *see* Muir, *supra* note 112.
[116] *Id.*
[117] Walt Disney Co. Derivative Litig., 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005); *see* Muir, *supra* note 112.

Duty of Loyalty

Under the duty of loyalty, corporate officers and directors must refrain from using their corporate position of trust and confidence for their own benefit.[118] The duty requires officers and directors not to profit at the expense of the corporation.[119] It is generally held under state corporate law that conflict situations will trigger a duty of loyalty analysis.[120] Unlike the duty of care, a conflict that triggers a duty of loyalty analysis rebuts the presumption that the directors acted in good faith and thus is not afforded the protection of the business judgment rule.[121] Upon a showing of the existence of a director conflict in a corporate transaction, the burden generally shifts to the party seeking to uphold the transaction to prove its validity.[122]

Duty to Monitor

The duty to monitor is not a separate fiduciary duty, but stems from the fundamental fiduciary duties of loyalty and care.[123] The duty to monitor includes a duty to attempt in good faith to assure that an adequate corporate reporting system exists, and the failure to do so under certain circumstances may render a director liable.[124] As one state court noted, the duty to monitor imposes a "continuing obligation to keep informed about the activities of a corporation."[125]

In fulfilling the duty to monitor, directors may rely in good faith on reports and other officers.[126] However, they may not then rely on them blindly.[127] Accordingly, some scenarios may require a director to seek out additional information that would support or refute information contained in reports or provided by officers.[128]

Effects of Sarbanes-Oxley on Delaware Corporate Law

Some critics have stated that Sarbanes-Oxley represents an "ill-advised advance in the creeping of federalism into corporate law."[129] Unlike the reforms prescribed by existing federal securities law, Sarbanes-Oxley departs the traditional disclosure based model and prescribes corporate governance reforms that had previously been wholly left to the states.[130] While the challenges with respect to implementation of the Act and the federalization of

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118 CEDE & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993); *see* Muir, *supra* note 112.
119 Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939); *see* Jones, *supra* note 2, at 648.
120 *Id.* at 452.
121 *CEDE*, 634 A.2d at 361; *see* Muir, *supra* note 112, at 447.
122 *Id.*
123 Omnimedia, Inc. v Martha Stewart Living, 833 A.2d 961, 971 (Del. Ch. 2003); *see generally* Lisa Fairfax, *The Sarbanes-Oxley Act as Confrmation of Recent Trends in Director and Officer Fiduciary Obligations*, ST. JOHN'S L. REV. (2002).
124 Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
125 Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981).
126 *Id.*
127 Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).
128 *Id.*
129 Stephen M. Brainbridge, *The Creeping Federalization of Corporate Law*, 26 REG. 32 (2003). *See* Jones, *supra* note 2, at 627.
130 Jones, *supra* note 2, at 629.

corporate governance are distinct, they are somewhat related. [131] State law regulation of corporate governance has offered the courts flexibility in applying standards for duties and independence, promoting "experimentation and differentiation" unlike the Act, which is "proscriptive" and employs a one size fits all approach.[132]

Delaware's Response to the Perceived Threat of Federal Preemption

It has been posited by Renee Jones that the Act appears to have affected the Delaware courts, which are ever mindful of Congress' preemptive power.[133] Jones has asserted that the "Delaware judiciary has taken the initiative to reform its state corporate law in an attempt to forestall further federal preemption."[134] Shortly after the financial failures of 2002, Delaware judges publicly expressed concerns in connection with the possibility of federal preemption if states did not react quickly to this situation.[135]

Early that same year, Delaware Vice-Chancellor Leo Strine wrote that "the Enron debate will create pressure on the current standards of state corporation law, and . . . participants in the policymaking process will identify what they perceive as inadequacies in that law, which they will cite as justifying a stronger role for federal regulation."[136] By August of 2004, perhaps in an effort to forestall preemption, "the Delaware Supreme Court has reversed chancery court decisions in favor of defendant directors and ruled for the shareholder-plaintiffs six times."[137]

Fiduciary Duty Cases

In a departure from the typical breach of fiduciary duties case, in 2004 the Delaware Court of Chancery sustained a plaintiff's breach of fiduciary duty claims in a corporate creditor case. [138] In *Production Resources Group v. NCT Group*, the plaintiff, a judgment creditor, asserted a breach of fiduciary duty claim against the company's chief executive officer and its chief financial officer.[139] Prior to bringing the claim in Delaware, the plaintiffs were originally attempting to enforce a $2,000,000 claim in the Connecticut court system.[140] The plaintiffs alleged mismanagement and the award of exorbitant salaries to the company's chief executive officer and chief financial officer despite the defendant's poor financial condition.[141]

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[131] Karmel, *supra* note 55.
[132] *Id.*
[133] *Id.* at 643.
[134] *Id.* The powerful parties in Delaware could suffer significantly in the event of broad federal preemption of state corporate law. Most obviously, uniform federal standards erode Delaware's appeal to corporate officers and directors which would result in substantial loss in tax revenue. Delaware lawyers would also be negatively affected by preemption, as they rely on revenues generated from serving as local Delaware counsel to corporations located throughout the country.
[135] Jones, *supra* note 2, at 644.
[136] Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on Corporate Law Implications of the Enron Debacle,* 57 BUS. LAW. 1371, 1372 (2002).
[137] Jones, *supra* note 2, at 645.
[138] Prod. Res. Group v. NCT Group, 863 A.2d 772 (Del. Ch. 2004).
[139] *Id.* at 774.
[140] *Id.*
[141] *Id.* The plaintiff asserted additional claims, but are not addressed herein.

NCT was an insolvent corporation whose controlling shareholder was the wife of a former director who controlled eight companies that acted as consultants to the corporation. Her latest cash financing was deposited in a subsidiary of the defendant to avoid creditor claims and, in consideration of such financing, she was issued preferred debt and warrants far in excess of that authorized by the defendant.[142] In its breach of fiduciary duty claims, the plaintiffs generally alleged that the board and the CEO and CFO of the defendant grossly mismanaged the company's finances and paid its officers exorbitant salaries.[143] While the court held that the generally pled mismanagement claim would be dismissed for failing to state a claim with particularity and for failing to plead such claim as a due care claim, the court upheld the plaintiff's claim with respect to the board's breach of fiduciary duty through its transactions with its major shareholder.[144] The court held that, taken together, the following factors created an inference of bad faith behavior: the former director's wife's status as controlling shareholder combined with payments made to her family's companies which consulted for the defendant; the award of inordinately large salaries to executives of the defendant; the issuance of unauthorized amounts of securities; and the use of a subsidiary of the defendant to avoid claims of creditors.[145] The court further held that "to the extent that directors have engaged in conscious wrongdoing or in unfair self-dealing, the exculpatory charter provision does not insulate them from fiduciary duty claims asserted on the firm's behalf by creditors."[146]

Jones also asserts that recent Delaware Jurisprudence has made it easier for plaintiffs to bring a duty of loyalty claim, specifically with respect to the use of the independent committee in the approval of conflict transactions.[147] The strict fairness traditionally applied to cash out mergers has applied to a wider range of cases including recapitalizations, corporate opportunity, and conflicts caused by corporate opportunity.[148]

In *Telxon Corp. v. Meyerson*, the Supreme Court of Delaware adopted a strict standard for director independence, and ruled that, due to the factual nature of inquiry as to a director's independence, summary judgment was not appropriate.[149] Prior to Sarbanes-Oxley, the defendant would likely have prevailed in motion for summary judgment, as Delaware's judicially-created rules, corporate-friendly statutes and procedural hurdles synergistically provided a formidable barrier to directors' monetary liability.[150] In *Telxon*, the plaintiffs asserted that the directors breached their duty of loyalty by allowing the chief executive officer to pursue a corporate opportunity to the detriment of the company.[151] The former CEO of the defendant, Robert Meyerson, was the key defendant in this case. Meyerson was asked to consult for the company when it began experiencing financial difficulty and then was asked to return as CEO when the incumbent CEO abruptly resigned.[152]

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142 *Prod. Res. Group*, 863 A.2d at 774.
143 *Id.* at 774-75.
144 *Id.* at 775-77
145 *Id.*
146 *Id.* at 795.
147 Jones, *supra* note 2, at 657.
148 *Id.*
149 802 A.2d 257, 264 (Del. 2002); *see also* Jones, *supra* note 2, at 646.
150 Jones, *supra* note 2, at 646.
151 *Texlon*, 802 A.2d at 261-62.
152 *Id.* at 260.

During the term of his consultancy, Meyerson developed a product within the scope of the defendant's business, and subsequently sold it to the company for over $17,000,000.[153] The plaintiffs alleged that such action was a breach of his duty of loyalty and that the directors also breached their fiduciary duties in approving the transaction.[154] In reversing the chancery court's motion for summary judgment, the Delaware Supreme Court concurred with the plaintiff's assertion that the directors' independence was questionable, thus challenging whether they had the ability to approve the transaction.[155] In its decision the court rejected the defendants' argument that they were entitled to protection under the business judgment rule because they were all independent, stating that "directors must not only be independent, but must act independently" and "it is the care, attention and sense of individual responsibility to the performance of one's duties … that generally touches on independence."[156]

In *Krasner v. Moffett*, the plaintiffs prevailed as the Delaware Supreme Court denied the defendant's motion to dismiss by rejecting a defense based on a special independent committee's ability to approve an interested party transaction.[157] In *Krasner*, two related corporations with certain board members in common established a special committee to approve a business combination between the two companies.[158] Pursuant to the terms of the merger agreement one of the parties was to receive a disproportionate amount of shares in the merged entity.[159] The plaintiffs asserted a breach of fiduciary duty action by claiming that the transaction was not fair in an attempt to invoke the entire fairness test and thus avoid the presumption of the business judgment rule.[160] The Chancery court determined at the pleading stage that the board's merger recommendation was entitled to the business judgment rule because two of the board members that comprised a special committee were sufficiently independent.[161] The Supreme Court of Delaware reversed, holding that since the analysis of independence involves a "fact intensive inquiry that varies from case to case, [and] thus we cannot determine at the pleading stage that the defendants will carry the burden of establishing independence."[162]

According to Jones, these cases have produced two new rules. [163] First, interested party transactions approved by "facially independent" directors are insufficient to protect such transactions from judicial scrutiny.[164] Second, there has been shift in the determination of independence from a judicial determination rendered at the pleading stage to a fact based inquiry entitling a plaintiff to avail itself of the discovery process and a trial. [165] Prior to the Act, these cases would likely have been ruled in favor of the defendants at the pleading stage, given the court's prior strong predilection in favor of director independence.

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[153] *Id*. at 261-62
[154] *Id*.
[155] *Id*. at 264-65.
[156] *Id*. at 264.
[157] 826 A. 2d. 277 (Del. 2003); *see also* Jones, *supra* note 2, at 659.
[158] *Id*. at 279-81.
[159] *Id*.
[160] *Id*. at 282.
[161] *Id*.
[162] *Id*. at 286.
[163] Jones, *supra* note 2, at 659.
[164] *Id*.
[165] *Id*.

IV. UNINTENDED CONSEQUENCES

Typically, cases for breaches of fiduciary duty are brought in state court by means of derivative actions or injunctive relief.[166] The Act's absence of any newly created federal civil liabilities may result in actions for non-compliance being brought in state court.[167] For example, an action may be brought in state court for a reporting company's failure to meet the corporate governance standards as set forth in its stock exchange listing agreement or a board's decision made with respect to executive compensation.[168]

Since civil litigation under the federal securities laws has resulted in numerous corporate reforms,[169] it is likely that numerous claims involving audit committees' action or inaction could result in the further constricting of corporate reforms that could discourage directors form taking entrepreneurial risks, given the heightened standards imposed on audit committees by the Act and Delaware's stringent application of its fiduciary duty laws. Prior to the Act, state courts gave deference to the business decisions made by corporate boards. However, the state court's recent trends in its strict application of independence standards, coupled with the SEC's creep into corporate governance, which appears to have provided a new basis for enforcing the duty of care, will likely constrain board members from taking entrepreneurial risks that they would otherwise have taken prior to such reforms.

The new rules with respect to audit committees may have created an adversarial model of corporate governance where the committee is placed in the position of second-guessing both the CEO and CFO as well as the company's auditors. While a healthy level of skepticism may be acceptable, and sometimes necessary, the rules as adopted create an environment in which the audit committee continually questions the credibility of the executive officers.

Requiring audit committees to be directly responsible for all matters related to the audit engagement has created an adversarial model of corporate governance that pits the audit committee against the CEO and CFO, who would typically be the front-line players with respect to such matters. This adversarial relationship will likely result in a decline in the overall competitiveness of the U.S. capital markets, as boards of directors are concerned with additional responsibilities placed on them by the Act as well as coping with the new corporate governance dynamic that results from the Commission's emphasis on investor protection.[170] Karmel has suggested that in changing the direction, the Act may result in "diminished entrepreneurial activity, corporate profitability and competitiveness."[171]

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[166] Karmel, *supra* note 55, at 138.

[167] *Id.* An exception to this is section 306(a) of the Act, which makes it "unlawful for any director or executive officer of an issuer to . . . purchase, sell or otherwise acquire or transfer any equity security of the issuer. . . during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service. . . as a director or executive officer." 15 U.S.C. § 7244 (2006).

[168] *Id.*

[169] Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); *see also* Karmel, *supra* note 55.

[170] Karmel, *supra* note 55, at 81.

[171] *Id.* On May 19, 2006, U.S. Senator Olympia J. Snowe, Chair of the Senate Committee on Small Business and Entrepreneurship, released a letter to Securities and Exchange Commission Chairman Christopher Cox about the growing trend of U.S. based companies undertaking initial Public Offerings overseas. Senator Snowe expressed concern for the high cost of complying with the Sarbanes- Oxley Act, especially for smaller companies, and asked Chairman Cox what Congress can do to encourage America's small businesses to pursue IPO's domestically. Senator Snowe noted a Government Accountability Office report she requested found that from 1999 through 2004 IPOs by companies with revenues of $25 million or less decreased substantially from 70

Another potential drawback of such overregulation is the potential shortage of directors who are both willing and qualified to serve on the audit committee. The addition of greater responsibilities combined with the adversarial position that audit committee members would be forced into could make the position much less appealing to potential directors. In a less regulated corporate governance model, such drawbacks could be countered with more generous remuneration offered for audit committee service. Under the Act, this would create a catch-22. Although audit committee members are permitted to receive nondiscretionary remuneration, if they were compensated appropriately for their new level of responsibilities, it would likely be viewed as an impairment of their independence.

Potential audit committee members may also be discouraged from serving because of potential secondary liability under section 20(a) "Control Person Liability."[172] In *Lernout & Hauspie*, the District Court of Massachusetts held that the plaintiffs had made sufficient allegations of control under section 20(a) to survive a motion to dismiss.[173] To assert a claim under section 20(a), the plaintiff must plead "an underlying violation by a controlled person or entity, and [that] the defendants controlled the violator."[174] While the court recognized that one's position as an audit committee member alone does not determine control person status, the court did say that, among other factors, access to the company's financial information and the signing of the company's Form 10-K did raise such an inference.[175]

It is important to note that, in determining control person liability, the court looked to the functions of the committees under pre-Sarbanes-Oxley regulations. Given the Act's demands that the audit committee be "directly responsible for the appointment, compensation, retention and oversight"[176] of a company's auditors, it is likely that their exposure to control person liability will only increase.

V. CONCLUSION

Karmel asserts that the adversarial corporate governance model is only setting companies up for failure in that audit committees "simply cannot carry the freight that the SEC has placed [on them]," and they are "bound to disappoint and cause investor dissatisfaction as

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percent of all IPOs in 1999 to about 46 percent in 2004. Ms. Snowe's letter also quoted former Federal Reserve Chairman, Alan Greenspan stating that he [was] "disturbed by the fact that initial public offerings have moved away from the U.S. and to a large extent have moved to London." Mr. Greenspan's remarks highlight a growing trend of small U.S. companies undertaking IPOs overseas, rather than remaining in the U.S., to raise capital. Many of these small inventive companies cite the high cost of complying with the Act as the major factor keeping them from growing through a U.S. based IPO. Committee on Small Business Entrepreneurship, Press Release from Senator Olympia Snowe available online at http://sbc.senate.gove/republican/HTML/news/US-BASEDIPO-Overseas.html

[172] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004).

[173] *Lernout & Hauspie Sec, Litig*., 286 B.R. 33, 39 (Bankr. D. Mass. 2002). Section 20(a) provides that any "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, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (2006).

[174] *Id.*

[175] *Id.* at 39-40.

[176] 15 U.S.C. § 78m-1 (2006).

well as a loss of confidence."[177] While the effects of the Act and the rules promulgated thereunder as well as the recent trends in application of state corporate law have not yet been fully realized, it is likely that this new dynamic created by the Act will have a detrimental effect not only on the ability of American companies to compete in the global marketplace but also on the very domestic capital markets for whose benefit the Act was adopted to the extent American companies are forced to seek relief through alternatives such as foreign markets.

[177] Karmel *supra* note 55, at 135.