COMMENT

WARNING! A POSITION ON THE AUDIT COMMITTEE COULD MEAN GREATER EXPOSURE TO LIABILITY: THE PROBLEMS WITH APPLYING A HEIGHTENED STANDARD OF CARE TO THE CORPORATE AUDIT COMMITTEE

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I. INTRODUCTION

Consider this problem:[1]

You are a practicing attorney and a member of the audit committee for a large, publicly held corporation, XYZ. One evening, you receive a telephone call from the chief financial officer of XYZ, and she sounds quite distressed. She explains that she has discovered that the corporation has been materially overstating its assets for the last three quarters. As a result, XYZ has published misleading information in its recent annual financial report. She warns you that this will result in a Securities and Exchange Commission (SEC) investigation, as well as shareholder class action lawsuits.

After the initial shock disappears, you start thinking about the possibility that you will be subject to liability because of your position on the audit committee. You think back over the last year and remember when you were asked to become a member of the audit committee. The company chose you to serve on the committee

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1. This hypothetical is loosely modeled after a hypothetical presented in Brian E. Pastuszenski & Kevin J. O'Connor, *Reducing Audit Committee Liability Dangers*, 20 Corp. Bd. 12 (Nov./Dec. 1999).

because of your accounting background (you have an undergraduate degree in accounting) and your status as an outside director. You knew that the job would include more responsibilities than you already had, but you were ready to accept the challenge. As you understood, it would be your duty to monitor the internal financial reporting process as well as to communicate with the external auditors.

Over the course of the past year, the audit committee met only three times. During these meetings, the committee reviewed reports submitted by management and internal auditors regarding XYZ's financial status. The company never had any major financial reporting problems in the past, and you trusted that the information you received was accurate. You relied, for the most part, on the information provided to you, because you lacked the time and the understanding necessary to conduct a detailed analysis. To the financially astute reader, the reports may have revealed some subtle signs that something was wrong, but the audit committee did not catch them. In fact, you were the only member who was formally trained in accounting. However, you are confident that, overall, the audit committee performed diligently.

At work the next day, you do some research to determine whether you will face any legal exposure. You discover that there was a case decided about eight years ago in your jurisdiction with similar facts in which the court denied the audit committee members' motions to dismiss. The court held that the audit committee members should be held to the same standard as inside directors because of the committee's extensive exposure to the company's inside financial information. Further, there were allegations that the committee was aware of the problem. You are concerned that a lawsuit could result in a substantial award. Now you begin to wonder why you did not research your decision to join the audit committee more thoroughly. Then, two weeks later, you learn that you are being sued because of your position on the audit committee.

This hypothetical presents very real concerns for audit committee members today. Case law is relatively sparse in this area, and the few decisions that address the issue of audit committee member liability do not provide much guidance regarding the standard of care to which an audit committee member will be held. However, there is a group of cases that has held audit committee members to

a higher standard of care than other outside directors on the board.[2] This approach has structural, functional, and practical flaws and, if followed, will result in heightened exposure to litigation for audit committee members. Additionally, newly adopted SEC rules applicable to audit committees, and recently published recommendations to improve audit committee effectiveness, will most likely result in increasing the scrutiny of the audit committee's performance.[3]

As one of the most "talked about" subjects in corporate law today,[4] the audit committee has become the focus of an ongoing effort to crack down on fraudulent financial reporting and provide more effective monitoring during the financial reporting process.[5] Class action securities fraud cases involving director fraud and financial reporting fraud are a serious threat to corporations.[6] As a result, audit committees are receiving more attention than ever, and, along with the increased attention, there arises an increasing concern about the potential liability for audit committee members.[7]

A pervasive theme throughout corporate and securities law is the idea of promoting investor confidence.[8] The ultimate goal is to

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2. For a thorough discussion of these cases, see *infra* notes 47–121 and accompanying text.

3. Natl. Assn. Corp. Dirs., *Report of the NACD Blue Ribbon Commission on Audit Committees, A Practical Guide* (2000); *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (n.d) [hereinafter *Millstein/Whitehead Report*]; SEC, *Final Rule: Audit Committee Disclosure* <http://www.sec.gov/rules/final/34-42266.htm> (last updated Jan. 10, 2000).

4. *Attention Brought to Bear on Boards' Audit Committees amid Questions on Financial Reporting, Performance by Firms*, 2 Corp. Governance Rep. 138, 138 (Dec. 6, 1999) [hereinafter *Attention*] (referring to the recent interest among the corporate community in improving the effectiveness of audit committees).

5. *Id.*; Pastuszenski & O'Connor, *supra* n. 1, at 13.

6. *Securities Fraud Litigation Sets Record in 1998* <http://securities.stanford.edu/news/990125/pressrel.html> (accessed Mar. 18, 2001) [hereinafter *Securities Fraud Litigation*]. According to the Stanford Securities Class Action Clearinghouse, at least 235 companies were sued in class action securities fraud lawsuits in 1998, which is an increase over the 227 companies sued in 1994. *Id.*; *see* Pastuszenski & O'Connor, *supra* n. 1, at 12 (noting the recent increase in the number of securities fraud class action cases).

7. *See* Martin Lipton et al., *Audit Committees — Some Observations*, 1156 P.L.I. Corp. L. & Prac. Course Handbook Series 739, 741 (Dec. 1999) (responding to the recent efforts by the SEC and New York Stock Exchange to improve audit committees).

8. *See e.g.* Arthur Levitt, *The "Numbers Game"* <http://www.sec.gov/news/speeches/spch220.txt> (accessed Mar. 5, 2000) (Remarks have been removed from the Web site since the Author conducted the research) (calling for a fundamental change in corporate management to improve the credibility of financial reporting). For further discussion of Chairman Arthur Levitt's remarks, see *infra* note 217 and accompanying text; *see* SEC, *Proposed Rule: Audit Committee Disclosure* <http://www.sec.gov/rules/proposed/34-

increase the reliability and accuracy of financial reporting so that investors will be confident in the market.[9] The audit committee plays a critical role in furthering this goal through enhancing financial statement reliability and credibility.[10] However, increasing the potential liability for these directors will not achieve this goal. This Comment will begin, in Part II, by providing background information as to the structure and role of the corporate audit committee, along with a brief review of the major historical developments leading up to the current focus on audit committees. In Part III, this Comment will address the small body of case law pertaining to the issue of audit committee member liability, focusing on the standard of care applied to audit committees. Part IV will address and analyze various problems with applying a heightened standard of care to audit committee members. Part V will present some recent major publications concerning audit committees, including new SEC rules, and will discuss the potential impact these new developments could have on audit committee member liability. Finally, Part VI will discuss what should be done to achieve the ultimate goal of accurate and reliable financial reporting and will address different approaches that can be taken to protect audit committee members from liability.

II. THE AUDIT COMMITTEE

A. The Structure and Role of the Corporate Audit Committee

Corporations generally have a small number of committees that serve to increase the board's overall effectiveness. The more common committees found in corporations — particularly large public corporations — are the audit committee, the compensation committee, the nominating committee, the executive committee, and the finance committee.[11] The board of directors' delegation of powers to these committees is governed by state law[12] and, while a corporation

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41987.htm> (last updated Oct. 8, 1999) (discussing the role of audit committees in the financial reporting process).

9. SEC, *supra* n. 8.

10. *Id.* (stating that "[a] properly functioning audit committee helps to enhance the reliability and credibility of financial disclosures").

11. Douglas M. Branson, *Corporate Governance* 198 (Michie Co. 1993).

12. *See e.g.* Del. Code Ann. tit. 8, § 141(c) (1991) (providing that board committees "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation," with some exceptions); Fla. Stat. § 607.0825(1) (2000) (providing that each committee "shall have and may exercise all the

may not have all of these committees, corporations listed on the New York Stock Exchange (NYSE) or National Association of Securities Dealers Automated Quotation System (NASDAQ) are required to have an audit committee.[13] However, neither the listing standards nor state corporate law or federal securities law provides much guidance on how the audit committee should be structured or how it should function.[14] For example, the NYSE Listing Standards state that "[e]ach domestic company seeking to list on the [NYSE] must have an Audit Committee comprised solely of directors independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member."[15] Although this standard requires "independence" for audit committee members, it provides no guidance as to what qualifications an audit committee member should possess or what functions an audit committee member should perform.

However, there is an abundance of literature providing recommendations on both the structure and functions of the corporate audit committee.[16] The committee should be composed of at least three outside directors who are independent of manage-

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authority of the board of directors"); N.Y. Bus. Corp. Laws § 712(a) (McKinney 1986) (providing that each committee "shall have all the authority of the board," with some exceptions); Rev. Model Bus. Corp. Act § 8.25(d) (ABA 1999) (providing that "each committee may exercise the authority of the board of directors under section 8.01," with some exceptions).

13. William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* vol. 1, § 1-4(a), 9–12 (6th ed., LEXIS L. Publg. 1998); John F. Olson et al., *Audit Committees of the Board of Directors: Duties and Liabilities*, 623 P.L.I. Com. L. & Prac. Course Handbook Series 163, 165 (June 4, 1992); NASDAQ, *4310. Qualification Requirements for Domestic and Canadian Securities* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=nasd4i8x info=/goodbye.htm> (accessed Oct. 13, 2000); NYSE, *NYSE Listing Standards and Procedures for Domestic Companies* <http://www.nyse.com/pdfs/liststnd.pdf> (accessed Oct. 13, 2000) (The report has been removed from the Web site since the Author conducted the original research.).

14. *Millstein / Whitehead Report*, *supra* n. 3, at 20; NYSE, *supra* n. 13, at 5.

15. NYSE, *supra* n. 13, at 5.

16. *See e.g. Millstein / Whitehead Report*, *supra* n. 3, at 10–16 (listing ten recommendations to improve audit committee effectiveness); Natl. Assn. Corp. Dirs., *supra* n. 3, at 1–26 (providing a thorough discussion on "best practices" that an audit committee should follow); John F. Olson, *How to Really Make Audit Committees More Effective*, 54 Bus. Law. 1097, 1098 (1999) (responding to the *Millstein / Whitehead Report* with a modified list of recommendations to improve audit committee effectiveness); Olson et al., *supra* n. 13, at 166–169 (offering general descriptions of an audit committee's functions and responsibilities); *Panel's Proposals on Audit Committees Get Mixed Reaction at ABA Annual Meeting*, 2 Corp. Governance Rep. 97, 97–98 (Sept. 6, 1999) [hereinafter *Panel's Proposals*] (discussing the *Millstein / Whitehead Report* and suggesting alternative ways to improve audit committee effectiveness).

ment.[17] The recommendations stress the importance of the members' independence from management.[18] Basically, the committee members should not have any business or familial relationship with the corporation.[19] The rationale is that independence from management will encourage committee members to ask probing questions and avoid simply "rubber-stamping" management decisions, as well as to bring fresh perspectives and ideas to the board. A director who is not an employee of the corporation will be more inclined to question management's decisions than a director who is an employee and arguably concerned about job security.[20] In contrast to outside directors, inside directors are both directors and officers of the company and are not considered independent.[21]

In general, members of the board of directors must meet the standard of care for directors set forth in the Revised Model Business Corporation Act.[22] It states that the duty of care for a director is met if the director acts "(1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests

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17. *Millstein/Whitehead Report*, *supra* n. 3, at 12; Natl. Assn. Corp. Dirs., *supra* n. 3, at 12. An outside director, for purposes of this Comment, is defined as a director who is not also an officer or employee of the company. *See e.g.* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 Nw. U. L. Rev. 898, 900–901 (1996) (noting that outside directors are commonly defined as those directors who are "not currently employed by the firm"); Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 Del. J. Corp. L. 25, 29 (1987) (defining independent outside directors as those directors "who have no present direct business relationship with the corporation on whose board they serve"). Thus, the chief executive officer of a corporation should not also serve on the corporation's audit committee. For example, Jon Nash, chairman of the National Association of Corporate Directors (NACD), describes the *ideal* audit committee as consisting of "an active or retired financially astute CEO, a retired partner from a big accounting firm, an active or retired chief financial officer, an active or retired internal auditor, an attorney with an accounting background, and an academician in accounting." *Panel Hears Opinions on Strengthening Audit Committees*, 2 Corp. Governance Rep. 12, 12 (Jan. 4, 1999) [hereinafter *Panel Hears*].

18. Natl. Assn. Corp. Dirs., *supra* n. 3, at 9 (recommending that "[a]ll audit committee members, in addition to possessing traits expected of all directors, should be independent"); *see Millstein/Whitehead Report*, *supra* n. 3, at 10 (providing two recommendations for strengthening the independence of audit committees).

19. Pease, *supra* n. 17, at 29–30; Natl. Assn. Corp. Dirs., *supra* n. 3, at 10 (stating that a director is considered independent if, among other things, he or she "is not a close relative of any management-level employee of the company").

20. Lin, *supra* n. 17, at 901.

21. Pease, *supra* n. 17, at 29 (describing inside directors as officers and employees of the company and also describing a third category of nonindependent outside directors including consultants, such as lawyers and bankers, whose businesses and corporations provide substantial services to the company).

22. Rev. Model Bus. Corp. Act § 8.30 (ABA 1999).

of the corporation" and oversees "with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[23] Some courts have interpreted this standard to hold inside directors to a higher standard of care than outside directors.[24] For example, in cases involving securities registration, a director can be found liable as a "controlling person" over someone who is in violation of Section 11 or 12 of the Securities Act of 1933.[25] An inside director is more at risk for violating these sections than an outside director, because the outside director, who is less likely to have knowledge of the daily operations of the company, can qualify for "no knowledge" defenses.[26] Similarly, some courts have recognized that an outside director should not be held to the same standard as an inside director who is employed by the corporation and is involved in its day-to-day operations.[27]

How can the outside directors possibly have the same level of knowledge about the corporation as inside directors when the board meets only a handful of times each year?[28] The obvious answer is that they cannot, and therein lies a difficult problem that the audit committee faces. Because the audit committee is composed, or at

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23. *Id.* § 8.30 (a), (b).

24. *E.g. Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 578 (E.D.N.Y. 1971) (holding that inside directors, accountants, and underwriters are required to conduct a more comprehensive investigation than outside directors); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 687–692 (S.D.N.Y. 1968) (differentiating between inside and outside directors in determining whether the directors successfully proved due diligence defenses); Meredith M. Brown & James H. Cheek, III, *Director Liability under the Federal Securities Law*, 907 P.L.I. Corp. L. & Prac. Course Handbook Series 443, 456 (Nov. 1995) (stating that "[i]nside directors are *expected to undertake more comprehensive investigations* than those mounted by outside directors," but also noting that some courts hold outside directors to high standards of investigation (emphasis added)); Olson, *supra* n. 16, at 1104 (implying that holding inside directors to a higher standard is a "valid principle," but outside directors should not be treated the same).

25. 15 U.S.C. §§ 78i, 78l (1994). Other than securities registration, there are several different activities performed by public companies that can invoke director liability under federal securities laws. Brown & Cheek, *supra* n. 24, at 445. These activities include periodic financial reporting, the solicitation of proxies, disclosure of company information to shareholders and the financial community, and trading in securities. *Id.*

26. *See* Alan Reinstein et al., *Corporate Audit Committees: Reducing Directors' Legal Liabilities*, 34 Def. L.J. 689, 693 (1985) (noting that outside audit committee members could be subject to a higher standard of care because of increased involvement in the daily operations in the company).

27. *See e.g. Rowen v. Le Mars Mut. Ins. Co. of Iowa*, 282 N.W.2d 639, 653 (Iowa 1979) (holding that outside directors may rely "within reasonable limits" on those who are primarily responsible for the business of the corporation).

28. Olson, *supra* n. 16, at 1106 (stating that the typical audit committee meets about three or four times a year).

least should be composed, of only outside directors, it is impractical to believe that the audit committee would have the same level of understanding and knowledge of the corporation's daily operations as inside directors.[29]

To understand the liability issues surrounding audit committee membership, insight into the functions an audit committee performs is necessary. The audit committee's primary function is to oversee the company's internal control and financial reporting process.[30] Although its other functions are important,[31] overseeing the financial reporting process — which includes reviewing manage-

29. *Id.* (noting that audit committee members cannot be internal auditors). However, audit committee members should take the time to learn about the company so that they can perform their jobs more efficiently. *Id.* at 1110. For a discussion on the limitations of the audit committee, see *infra* Part IV.

30. Knepper & Bailey, *supra* n. 13, at 9–12 (listing the several ways in which an audit committee performs its monitoring functions); Olson et al., *supra* n. 13, at 167; *see* A.A. Sommer, Jr., *Internal Controls*, 61 N.C. L. Rev. 505, 511 (1983) (noting that audit committees are used to "assur[ing] compliance with good systems of control"). Sommer describes a company's internal control system as consisting of accounting controls and management controls. *Id.* at 506. Generally, it includes "everything that contributes to the existence and continued well-being of the corporation." *Id.*

31. Olson et al., *supra* n. 13, at 166–169; ALI, *Principles of Corporate Governance: Analysis and Recommendations* § 3A.03 (ALI Publishers 1994). Section 3A.03 recommends that the audit committee should,

> (a) Recommend the firm to be employed as the corporation's external auditor and review the proposed discharge of any such firm;
> (b) Review the external auditor's compensation, the proposed terms of its engagement, and its independence;
> (c) Review the appointment and replacement of the senior internal auditing executive, if any;
> (d) Serve as a channel of communication between the external auditor and the board and between the senior internal auditing executive, if any, and the board;
> (e) Review the results of each external audit of the corporation, the report of the audit, any related management letter, management's responses to recommendations made by the external auditor in connection with the audit, reports of the internal auditing department that are material to the corporation as a whole, and management's responses to those reports;
> (f) Review the corporation's annual financial statements, any certification, report, opinion, or review rendered by the external auditor in connection with those financial statements, and any significant disputes between management and the external auditor that arose in connection with the preparation of those financial statements;
> (g) Consider, in consultation with the external auditor and the senior internal auditing executive, if any, the adequacy of the corporation's internal controls;
> (h) Consider major changes and other major questions of choice respecting the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements, when presented by the external auditor, a principal senior executive, or otherwise.

ALI, *supra* n. 31, at § 3A.03 (citation omitted).

ment's preparation of the financial statements and reviewing the work of the independent auditor — is probably the most critical function.[32] In performing its oversight and monitoring functions, the audit committee serves as a communication link between the independent outside auditors, the internal auditors of the corporation, the board of directors, and management.[33] An important — but often forgotten — aspect is that the audit committee's role does not include preparing financial statements; it is strictly a monitoring committee.[34] Management prepares the financial statements and the outside auditor determines whether the financial statements have been fairly and accurately presented.[35] Therefore, the committee must rely on both management and outside auditors to function effectively.[36] The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees[37] in its report describes the audit committee, outside auditors, and financial management as forming a "three-legged stool" supporting "responsible financial disclosure and active and participatory oversight," while recognizing that the audit committee, as an extension of the full board, is "the ultimate monitor of the process" and must be "first among equals."[38]

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32. Olson et al., *supra* n. 13, at 166–169; Natl. Assn. Corp. Dirs., *supra* n. 3, at 5 (stating that one of the "primary purposes of an audit committee [is] to foster and oversee strong financial reporting and controls"). Another important and sometimes neglected function of the audit committee is focusing on risk assessment. The risks that companies must deal with include "competitive, environmental, financial, legal, operational, regulatory, strategic, and technological" risks. Natl. Assn. Corp. Dirs., *supra* n. 3, at 6.

33. Knepper & Bailey, *supra* n. 13, at 9; Indep. Stands. Bd., *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees* <http://www.cpa independence.org/> (accessed Mar. 18, 2001) (requiring that independent auditors discuss their independence with the audit committee on an annual basis); SEC, *supra* n. 8 (discussing the audit committee's role in communicating with the board of directors, management, internal auditors, and external auditors).

34. Olson et al., *supra* n. 13, at 167 (describing that the audit committee reviews the job that "management has done in *developing* and *presenting* the company's financial statements" (emphasis added)).

35. The audit process performed by the outside auditor to determine the fairness and accuracy of the financial statements is beyond the scope of this Comment. Joseph I. Goldstein & Catherine Dixon, *New Teeth for the Public's Watchdog: The Expanded Role of the Independent Accountant in Detecting, Preventing, and Reporting Financial Fraud*, 44 Bus. Law. 439, 441–442 (1989).

36. *Millstein/Whitehead Report*, *supra* n. 3, at 7 (explaining that because the audit committee's job does not include preparing the financial statements, it relies on management to perform its oversight duties).

37. The Blue Ribbon Committee is a committee of experts, scholars, and practitioners formed at the request of the SEC to develop recommendations for improving corporate audit committees. *Id.* at 8.

38. *Id.* at 7.

Thus, the audit committee's oversight role is vital to the financial reporting process.

B. Historical Developments of the Audit Committee

Although audit committees only recently have become one of the primary targets of the focus on financial reporting, promoting audit committee effectiveness began as early as the 1940s.[39] Since then, there have been several significant developments that have had an effect on the audit committee. These developments have sought to improve various aspects of the audit committee in an effort to improve the financial reporting process.

The enactment of the Foreign Corrupt Practices Act in 1977 introduced internal accounting requirements and set the stage for the external focus on audit committees.[40] Also in the 1970s, the SEC adopted rules that required the audit committee to make certain disclosures, such as the existence of the committee and the functions performed by the committee.[41] Then in 1987, the National Commis-

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39. *In re McKesson & Robbins, Inc.*, Acctg. Series Release 19, Exch. Act Release 2707 (SEC Dec. 5, 1940).

40. 15 U.S.C. § 78m (1994). A series of bribery scandals in the 1970s seriously affected public confidence in American business and prompted Congress to enact the Foreign Corrupt Practices Act. Kari Lynn Diersen, *Foreign Corrupt Practices Act*, 36 Am. Crim. L. Rev. 753, 753–754 (1999). The relevant portions of the Act are as follows:

> Every issuer which has a class of securities registered pursuant to section 78*l* . . . and every issuer which is required to file reports pursuant to section 78*o*(d) . . . shall—
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> (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
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> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
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> (i) transactions are executed in accordance with management's general or specific authorization;
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> (ii) transactions are recorded as necessary
>
> (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
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> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
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> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

15 U.S.C. § 78m(b)(2)(A)–(B).

41. 43 Fed. Reg. 58522, 58527 (Dec. 14, 1978) (requiring disclosure of the functions of the audit committee); 40 Fed. Reg. 1010, 1012 (Jan. 6, 1975) (requiring disclosure of the existence of the audit committee).

sion on Fraudulent Financial Reporting (Treadway Commission), headed by James Treadway, a former SEC commissioner, issued a report of recommendations focusing on the following three aspects of fraudulent financial reporting: (1) factors that contribute to fraudulent financial reporting, (2) the independent accountant's role, and (3) the corporation's role.[42] The report made several recommendations directly related to audit committees.[43] In 1991, the Federal Deposit Insurance Corporation Improvement Act required financial institutions to have audit committees made up of independent directors.[44] Then, in 1992, the American Law Institute proposed guidelines for audit committee responsibility.[45] Finally, 1999 has been one of the most active years for audit committee developments.[46]

III. CASE LAW ADDRESSING AUDIT COMMITTEE MEMBER LIABILITY

As mentioned previously, the case law pertaining to the issue of audit committee member liability is sparse and undeveloped. A review of these cases reveals little guidance about the direction in which the courts are headed on the issue of audit committee member liability, primarily because these cases deal only with motions to dismiss and motions for summary judgment.[47] However,

42. *Report of the National Commission on Fraudulent Financial Reporting* 2 (Oct. 1987) [hereinafter *Treadway Commission*]; *see* Olson et al., *supra* n. 13, at 174 (discussing the Treadway Commission's recommendations concerning audit committees).

43. *Treadway Commission*, *supra* n. 42, at 40–47 (recommending that the SEC require companies to have audit committees consisting of independent directors, "[a]udit committees should be informed, vigilant, and effective overseers of the financial reporting process," and "[a]udit committees should oversee the quarterly reporting process").

44. 12 U.S.C. § 1831m(g)(1)(A) (1994). The Federal Deposit Insurance Corporation Improvement Act was enacted to "recapitalize and protect the bank insurance funds, reform the deposit insurance system, and improve supervision of federally insured depository institutions, including foreign banks." Stephen K. Huber, *The Federal Deposit Insurance Corporation Improvement Act of 1991*, 109 Banking L.J. 300, 300 (1992).

45. ALI, *supra* n. 31, at § 3.05.

46. For a discussion of the recent developments regarding the audit committee, see *infra* Part V. In 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees published its report and recommendations, the NACD headed its own Blue Ribbon Commission that published a practical guide for audit committees, and the SEC adopted final rules regarding audit committee disclosures. *Supra* n. 3 and accompanying text.

47. In deciding a motion to dismiss, a court is required to view the complaint in the light most favorable to the plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). The Federal Rules of Civil Procedure require only "a short and plain statement of the claim." Fed. R. Civ. P. 8(a) (1999). Further, a plaintiff can prevail on a motion for summary judgment if there is

for current and prospective audit committee members to be fully informed on this issue, an analysis of these cases and the reasons underlying these decisions is critical.

In the following group of cases, the courts applied a higher standard to the audit committee members than would be applied to other directors. These cases should be of particular concern to audit committee members because of the increased potential of liability exposure created by the courts' decisions.

Tischler v. Baltimore Bancorp[48] involved two banks, one of which was offering to buyout the other.[49] First Maryland Bank announced that it would pay seventeen dollars per share to buy Baltimore Bancorp (Bancorp), subject to a review of Bancorp's financial records.[50] In response, Bancorp hired an outside financial advisor to review its financial records, and, after Bancorp provided misleading information to the outside financial advisor, the advisor determined that the seventeen-dollar price per share was inadequate.[51]

As a result, Bancorp rejected First Maryland's offer and issued a press release stating that the seventeen-dollar price per share was inadequate.[52] However, the press release misled investors into believing that Bancorp's stock was worth over seventeen dollars per share when it was actually only worth five and one-eighth dollars per share after First Maryland withdrew its offer.[53] The plaintiff, Tischler, was an individual who purchased Bancorp stock after Bancorp's press release, at a purchase price of nearly three times its actual value.[54] After a sharp decline in Bancorp's stock price, he

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a "genuine issue as to any material fact." Fed. R. Civ. P. 56(c) (1999). Thus, a court looks at the evidence and determines whether "a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986).

48. 801 F. Supp. 1493 (D. Md. 1992).

49. *Id.* at 1495.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 1495–1496. Following Bancorp's rejection of First Maryland's seventeen dollar per share offer, Bancorp's stock price rose to about fifteen dollars per share. *Id.* at 1496. First Maryland renewed its offer, which Bancorp rejected, relying on the advice of the outside directors. *Id.* On the date First Maryland withdrew its offer, the stock was worth significantly less. *Id.*

54. *Id.*

sued Bancorp and its directors alleging various securities violations.[55]

In denying the audit committee members' motions to dismiss, the federal district court held that the audit committee members had "inside knowledge" of Bancorp's financial status, and, because they did not question the information presented to them despite the inconsistency with information that was "necessarily known to them," they could be held liable for causing or permitting the issuance of false and misleading statements.[56] The complaint alleged that the audit committee members had knowledge that the press release was inaccurate.[57] In its reasoning, the court separated the audit committee from Bancorp's other outside directors.[58] The other outside directors did not have the same "inside" knowledge as those serving on the audit committee, because there were no allegations that the other outside directors had knowledge of the financial

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55. *Id.* Primarily, the plaintiff alleged violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. *Id.* Section 10(b) states in part that "[i]t shall be unlawful . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary." 15 U.S.C. § 78j(b) (1994). Further, Rule 10b-5 states in part that,

> It shall be unlawful
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> . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2000).

56. *Tischler*, 801 F. Supp. at 1501. The complaint alleged that the audit committee was responsible for supervising management and handling various financial matters of the bank. For example, the audit committee was responsible for supervising management and verifying the assets, collateral, and loan values. *Id.*

57. *Id.* Because of the audit committee's responsibilities, the court agreed with Tischler that the audit committee should have known that First Maryland's offer was not inadequate. *Id.*

58. *Id.* at 1500–1501. The court determined that outside directors fell into three categories: (1) the audit committee, (2) the alleged experts (outside directors with investment, banking, real estate, or insurance experience), and (3) the others. *Id.* The court also denied the alleged experts' motion to dismiss, but noted that the court would "carefully examine" a summary judgment motion to ensure there was adequate evidence against those directors to treat them as insiders. *Id.* at 1502. Interestingly, the court did not say this with regard to the audit committee. *Id.* at 1501.

position of the bank or the banking industry.[59] However, those outside directors serving on the audit committee were treated the same as management (inside directors).[60]

Other courts have reached similar decisions as the court reached in *Tischler* by treating the audit committee members as inside directors. In *Greenfield v. Professional Care, Incorporated*,[61] Professional Care (PC), a home health care company, was involved in a scheme to defraud New York's medicaid program.[62] As a result, PC and several directors were indicted for falsifying business records, grand larceny, and conspiracy.[63] The plaintiffs, those shareholders who purchased and retained stock during this period of activity, sued PC and its directors for causing the issuance of false and misleading statements.[64] Among the directors being sued were members of the audit committee who were responsible for monitoring internal and external audit functions, the financial reporting process, and control systems.[65] In denying the audit committee members' motions to dismiss, the court stated that the members appeared to be more like inside directors than outside directors because of the allegations of the audit committee members' actual knowledge or reckless disregard of fraud.[66] Thus, the audit committee defendants were held to the same standard as the inside directors.[67]

In *In re AM International, Incorporated Securities Litigation*,[68] in which the defendants also filed a motion to dismiss, the audit committee defendants were held to the same standard as the inside directors because of the committee's access to company information and its responsibility for reviewing the external audit.[69] The

59. *Id.* at 1502. In addition, the court noted that outside directors are not required to question management's decisions without proof or suspicion of wrongdoing. *Id.* This same standard should be applied to the audit committee members.

60. *Id.* at 1501.

61. 677 F. Supp. 110 (E.D.N.Y. 1987).

62. *Id.* at 112. The scheme was that PC would file claims for services performed by individuals who did not qualify for reimbursement. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 114–115.

66. *Id.* at 115. The particular allegations noted by the court were that the defendants signed an amended registration statement and Form 10K after the corporation, including corporate counsel, was informed by the State of the investigation of the charges of falsifying business records, grand larceny, and conspiracy. *Id.* at 112, 115.

67. *Id.* at 115.

68. 606 F. Supp. 600 (S.D.N.Y. 1985).

69. *Id.* at 605.

complaint alleged that AM International issued financial statements containing material misrepresentations and omissions.[70] Thus, the court held that, because of the defendants' "insider status," they could be held to the same standard of liability as the management defendants.[71] The audit committee members relied on case law, arguing that it should not be liable because of the "outside" status of its directors.[72] This argument was rejected because the defendant in *AM International*, unlike other defendants, was allegedly aware that the company's reports were false or misleading.[73] In determining that the audit committee members were "much closer to the position occupied by an inside director," the court focused on allegations that the audit committee had access to financial status information, was aware of most of the company's financial problems, and was responsible for reviewing the audits.[74]

In *In re MTC Electronic Technologies Shareholders Litigation*,[75] the audit committee defendants' motions to dismiss were denied on the basis that the plaintiff's allegations revealed accounting fraud.[76] Thus, because the audit committee members were charged with overseeing the accountants, they were treated as insiders.[77] The complaint alleged violations of federal securities laws.[78] The audit committee members allegedly signed a company prospectus containing materially misleading information.[79] The fact that the audit committee members signed the prospectus was enough to treat them as inside directors under a Rule 9(b) analysis.[80] Further,

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70. *Id.* at 604.

71. *Id.* at 605.

72. *Id.* The audit committee relied on *Lanza v. Drexel and Company*, 479 F.2d 1277, 1288–1289 (2d Cir. 1973), which held that an outside director who was neither aware nor suspicious of any deception of the plaintiffs was not liable under Section 10(b).

73. 606 F. Supp. at 605.

74. *Id.*

75. 898 F. Supp. 974 (E.D.N.Y. 1995), *vacated in part*, 993 F. Supp. 160 (E.D.N.Y. 1997).

76. *Id.* at 980.

77. *Id.*

78. *Id.* at 978. The complaint alleged violations of Section 10(b) and Section 20(a) of the Securities Exchange Act and Rule 10b-5 of the Code of Federal Regulations. *Id.*

79. *Id.* at 980.

80. *Id.* (relying on *Kimmel v. Labenski*, 1988 WL 19229 at *4 (S.D.N.Y. Feb. 10, 1988), which held that "'no specific connection between fraudulent representations . . . and particular defendants is necessary where . . . defendants are insiders'" under a Rule 9(b) analysis (quoting *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987)). The allegations include violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934. *In re MTC Elec. Techs.*, 898 F. Supp. at 978. The plaintiff's allegations reveal "massive accounting fraud," thus the allegations are governed by Rule 9(b) of the Federal Rules of Civil Procedure. *Id.* at 979. Rule 9(b) states that "[i]n all averments of fraud

the court added that even if the audit committee defendants were "outsiders" for the purposes of a Rule 9(b) analysis, the investment activities of the audit committee members in MTC, during the period out of which the action arose, were sufficient to raise strong inferences of fraud.[81]

Besides being held to a higher standard than other outside directors, the audit committee members have also been the only outside directors sued in some cases. *In re JWP Incorporated Securities Litigation*[82] involved a class action suit against inside directors and officers, the audit committee, and the independent auditor of JWP Inc. (JWP).[83] JWP, which began as a small water utility company in 1980, grew to become an international conglomerate by 1992 through acquisitions of smaller companies in various fields.[84] In 1993, JWP went bankrupt after the discovery of several accounting problems.[85] As a result, the class action suit included the audit committee members as named defendants and claimed violations of federal securities laws as well as common law claims.[86] Subsequently, the audit committee sought summary judgment.[87]

To be liable under a Section 10(b) analysis, the defendant must have made the misrepresentations and must have acted with the requisite fraudulent intent.[88] The court granted summary judgment in favor of the audit committee with respect to the misrepresentations released by management and not actually made by the audit committee.[89] However, the motion for summary judgment was

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. . . the circumstances constituting fraud . . . shall be stated with particularity." Fed. R. Civ. P. 9(b) (1999).

81. *In re MTC Elec. Techs.*, 898 F. Supp. at 980 n. 4. Both of the audit committee members were substantial investors in the company, and one of the members exercised stock options for a large profit during the period of fraud. *Id.*

82. 928 F. Supp. 1239 (S.D.N.Y. 1996).

83. *Id.* at 1246.

84. *Id.* at 1245.

85. *Id.* at 1245–1246. JWP was required to restate its audited financial statements for 1990 and 1991, as well as interim financial statements in 1992 because of the accounting irregularities discovered by the company's president. *Id.*

86. *Id.* at 1246–1247, 1255. There were actually three sets of plaintiffs asserting claims against the audit committee. *Id.* at 1246. Combining all of the claims, the audit committee was sued for violation of Section 10(b) and Section 20 of the Securities Exchange Act of 1934, common law fraud, negligent misrepresentation, violation of Section 12(2) and Section 15 of the Securities Act of 1933, and tortious interference with a contract. *Id.* at 1255. However, the relevant claims for the purposes of this Comment are the claims for violation of Section 10(b) and Section 20 of the Act.

87. *Id.* at 1255.

88. *Id.* at 1256. For the language of Section 10(b), see *supra* note 55.

89. *Id.*

denied as to statements in the company's annual reports, because the audit committee signed those reports.[90] Further, there was sufficient evidence to conclude that the audit committee acted with sufficient recklessness to infer fraudulent intent.[91] This evidence included letters from the outside auditor to the audit committee indicating that the internal audit department was an area of concern in the company, even though an improvement had been made.[92]

The plaintiffs also asserted a claim for violation of Section 20 of the 1934 Act, alleging that the audit committee members were liable as "controlling persons."[93] The court applied a two-part analysis to determine whether the audit committee members were liable as "controlling persons."[94] The first part of the analysis is "whether the nature of the relationship between the purported controller and controllee is such that the defendant possesses the actual authority to influence and direct the activities of the primary wrongdoer."[95] The second part of the analysis provides that "even if the defendant has such authority, a defendant is not liable unless he is also a culpable participant in the fraud."[96] In holding that the audit committee members could be found liable as controlling persons, thus denying their motion for summary judgment, the court focused on the responsibilities of the committee.[97] The responsibility to oversee the independent auditor and make reports and suggestions to the board was sufficient evidence to raise an inference that the audit committee controlled the actions of those involved in the financial reporting process.[98]

However, not all courts have been willing to bestow an "insider status" on the audit committee. For example, in *Haltman v. Aura*

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90. *Id.* at 1256–1257.

91. *Id.* at 1257.

92. *Id.*

93. *Id.* at 1259. Section 20 of the Securities Exchange Act of 1934 states in part 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 . . . to the same extent as such controlled person . . . unless the controlling person acted in good faith." 15 U.S.C. § 78t(a) (1994).

94. *In re JWP Inc.*, 928 F. Supp. at 1259.

95. *Id.*

96. *Id.*

97. *Id.* at 1260.

98. *Id.* However, the court did recognize that an inference could be drawn that the audit committee defendants perform only an advisory and monitoring function, and that "only the full Board of Directors . . . had the actual authority to influence and direct JWP's accounting policies." *Id.*

Systems, Incorporated,[99] the plaintiffs alleged that Aura created misconceptions about the company's ability to generate profits by issuing optimistic statements about a new business strategy.[100] The court recognized that, in cases of corporate fraud, a plaintiff could satisfy Rule 9(b) by using group pleading presumptions.[101] This "group pleading presumption is based on the theory that officers involved in the day-to-day management of the corporation must be aware of the corporation's internal operations"; accordingly, it "does not necessarily encompass every officer of a corporation."[102] However, this theory would not apply, because the audit committee defendant was an outside director not involved in the "day-to-day management" of the company.[103] In the case of the outside directors, the plaintiffs were required to allege a "special relationship or status with the corporation."[104]

The plaintiffs argued that the defendant's "membership on the [a]udit committee constitute[d] a special relationship with Aura that would indicate that he had direct or indirect control over the conduct of Aura's affairs."[105] The court rejected this argument, holding that the defendant's "status as a member of Aura's Audit Committee, in and of itself, is insufficient to link him to the alleged fraud."[106] There were no allegations that the defendant had a particular role in creating the alleged misleading statements.[107]

In *In re Oak Technology Securities Litigation*,[108] the court held that "[a]llegations that outside directors merely held positions on committees responsible for the preparation and disclosure of a corporation's finances are insufficient to set forth the circumstances constituting fraud with particularity."[109] This case is similar to

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99. 844 F. Supp. 544 (C.D. Cal. 1993).
100. *Id.* at 546.
101. *Id.* at 547.
102. *Id.* at 548.
103. *Id.*
104. *Id.* at 548–549.
105. *Id.* at 549.
106. *Id.*
107. *Id.*
108. 1997 WL 448168 (N.D. Cal. Aug. 1, 1997).
109. *Id.* at *11; *see In re Cendant Corp. Sec. Litig.*, 190 F.R.D. 331, 335 (D.N.J. 1999) (holding that when pleading fraud against the outside directors of the company, "'allegations that a securities fraud defendant, because of his position within the company, "must have known" a statement was false or misleading are "precisely the types of inferences which [courts], on numerous occasions, have determined to be inadequate to withstand Rule 9(b) scrutiny"'" (quoting *In re Advanta Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999) (alterations in original)).

Haltman, because it involves allegations that the directors of the company deceived the public by issuing misleading financial statements and misleading positive forecasts for future revenues.[110] The plaintiffs alleged that the audit committee members were liable, because they approved the issuance of the company's financial statements.[111] In dismissing the plaintiffs' complaint, the court held that these allegations did not meet Rule 9(b) standards for pleading fraud, which require attribution of "fraudulent acts or statements to a particular defendant."[112]

Also, the court in *Bomarko, Incorporated v. Hemodynamics, Incorporated*[113] held that "titles and functions alone do not establish 'controlling person' status."[114] The case involved allegations of various securities laws violations committed by Hemodynamics, a corporation engaged in exploring and acquiring rights to technology in the medical field.[115] The plaintiffs alleged that they purchased stock in Hemodynamics in reliance on public information that overstated the company's financial position.[116] The audit committee members were among the named defendants and moved for summary judgment as to the claims against them.[117]

In granting the motion for summary judgment, the court held that the audit committee members had not participated in the issuance of the false and misleading financial statements.[118] The court focused on the defendants' conduct rather than the mere fact that they held a position on the committee.[119] The audit committee members' regular attendance at board meetings, informal communications, and review of a letter from the outside auditors was not sufficient to establish that the audit committee members participated in the issuance of the statements.[120] Some of the key facts upon which the court relied were that the audit committee members did not have any accounting expertise and that they were concerned

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110. *In re Oak Tech.*, 1997 WL 4488168 at *1.
111. *Id.* at **11–12.
112. *Id.* at *10.
113. 848 F. Supp. 1335 (W.D. Mich. 1993).
114. *Id.* at 1339.
115. *Id.* at 1338.
116. *Id.*
117. *Id.* at 1338–1339.
118. *Id.* at 1341.
119. *Id.* at 1340.
120. *Id.* at 1340–1341.

about the lack of information they received from the inside directors.[121]

IV. PROBLEMS WITH HOLDING AUDIT COMMITTEES TO A HIGHER STANDARD OF CARE

It is apparent that the cases described in Part III do not provide a sufficient analysis of audit committee member liability, because they do not take into account the audit committee's structure, function, or practical limitations.[122] What guidance, if any, do these cases provide regarding the standard of care that audit committee members will be held to in the future? The courts that have applied an "insider" analysis to the audit committee have primarily focused on allegations regarding the audit committee's actual knowledge of the company's fraudulent activities.[123] However, courts that have classified the audit committee members as inside directors are creating heightened exposure to liability for audit committee members who do not have knowledge of fraud.

Some courts seem to suggest that audit committee members have inside knowledge of the company merely because of their position on the audit committee. For example, the court in *Tischler* essentially held that the audit committee members could be found liable for securities violations because of their inside knowledge of financial information, while other outside directors, who lacked any special inside knowledge, could avoid liability.[124] Furthermore, some courts have focused on the responsibilities and functions of the audit

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121. *Id.* at 1340. The defendants became audit committee members primarily because of their outside status as directors of the corporation. *Id.*

122. Those cases are representative of the issues addressed by the courts in determining audit committee liability. For more examples, see *Stack v. Lobo*, 903 F. Supp. 1361, 1377 (N.D. Cal. 1995) (holding that the group pleading doctrine under Rule 9(b) does not apply to outside directors merely because of their position on the audit committee), *In re First Merchants Acceptance Corporate Securities Litigation*, 1998 WL 781118 at **12–13 (N.D. Ill. Nov. 4, 1998) (holding that allegations that the audit committee members' positions as directors and their ability to prevent the issuance of false and misleading documents were sufficient to establish control person liability for purposes of withstanding a motion to dismiss), and *In re Livent, Incorporated Securities Litigation*, 78 F. Supp. 2d 194, 222 (S.D.N.Y. 1999) (holding that for purposes of control person liability, audit committee members can be presumed to have the power to direct management and corporate policies, but that the plaintiff failed to allege any culpable conduct on the part of the audit committee).

123. *Tischler*, 801 F. Supp. at 1501; *Greenfield*, 677 F. Supp. at 115; *In re AM Intl.*, 606 F. Supp. at 605.

124. 801 F. Supp. at 1502 (holding that the outside directors who were not members of the audit committee were not alleged to have any knowledge of Bancorp's financial position or of the banking industry in general).

committee in determining that the audit committee members are analogous to inside directors.

In the effort to attain the goal of a more reliable and credible financial reporting process, an effective audit committee plays a critical role as an overseer and monitor of the process. However, the courts must fully understand the duties, responsibilities, and inherent limitations of the audit committee to formulate a standard that the audit committee can satisfy as a practical matter through its duty of care. The following discussion will analyze the structural, functional, and practical reasons why courts should not apply this heightened standard of care to audit committees.

A. Structural Problems

Holding audit committee members to a higher standard of care than other outside directors will not improve the financial reporting process. There are limitations inherent in the committee's structure that make satisfying the heightened standard impracticable.[125] The typical audit committee consists of three or four outside directors independent of management. In applying a heightened standard of care, the most important structural limitation of an audit committee is the committee members' "independence" from management.[126]

The New York Stock Exchange requires companies listed on the exchange to have an audit committee that consists of "directors independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member."[127] Further, the Blue Ribbon Committee and the NACD both recently recommended that the audit committee be composed solely of independent directors.[128] Additionally, practi-

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125. The "structure" of the audit committee refers to the directors who are members of the committee.

126. *Millstein / Whitehead Report*, *supra* n. 3, at 10. The Blue Ribbon Committee stated that directors are "independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation." *Id.*

127. NYSE, *supra* n. 13, at 5.

128. *Millstein / Whitehead Report*, *supra* n. 3, at 10–11; Natl. Assn. Corp. Dirs., *supra* n. 3, at 9. The *Millstein / Whitehead Report* details the relationships that may destroy director independence. They are as follows:

> [1] a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
>
> [2] a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
>
> [3] a director being a member of the immediate family of an individual who is, or has

tioners recognize the importance of the independence of the audit committee, as well as the importance of a substantially independent board.[129]

It is important that the audit committee members are independent, because the committee must be able to question and criticize management freely, and an inside director's ability to question and criticize top management is questionable due to the inside director's reliance on his relationship with the company to advance his career.[130] For example, a study involving more than 200 fraud cases over an eleven-year period found that family relationships among the directors or officers were fairly common in companies charged with financial statement fraud.[131] This data supports the theory that inside directors are less likely than outside directors to uncover fraud in their own company. Clearly, it is critical that audit committees are staffed with outside directors to effectively fulfill their duties as monitors.

If the importance of an audit committee member's role as an independent director is clear,[132] then why would some courts hold the audit committee to the same standard of care that is applied to

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> been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
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> [4] a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years;
>
> [5] a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

Millstein / Whitehead Report, *supra* n. 3, at 10–11 (footnote omitted).

129. Simon M. Lorne, *Corporate Governance and the Audit Committee*, 1134 P.L.I. Corp. L. & Prac. Course Handbook Series 501, 523 (Aug. 1999) (discussing that independence is important for both the audit committee member and the source of information relied on); *but see* Catherine M. Daily & Dan R. Dalton, *Does Board Composition Affect Corporate Performance? No!*, 24 Directorship 7, 7–8 (Jul./Aug. 1998) (noting that after reviewing 159 studies of 40,160 companies, over a span of 40 years, "[t]here is no evidence of a systematic relationship between board composition and company financial performance" and further stating that independence of the board committees may be the most beneficial).

130. Lin, *supra* n. 17, at 901–902. However, some theories do state that management dominates the board regardless of the board's composition. *Id.* at 902.

131. Mark S. Beasley et al., *Audit Committees: The Rising Expectations*, 20 Corp. Bd. 1, 2 (Jul./Aug. 1999) (describing that "[h]alf of the frauds involved overstating revenues" and the other half involved overstating assets).

132. *See e.g.* Olson, *supra* n. 16, at 1111 (explaining that audit committee members need to question management and the outside auditors with "an attitude of healthy skepticism"); Curtis H. Barnette, *Realistic Expectations for Audit Committees*, 23 Dirs. & Bds. 29, 29 (Winter 1999) (stating that the Business Roundtable "support[s] strong audit committees that question both internal and external auditors").

the inside directors? Perhaps one reason is that the audit committee's duties include questioning and challenging those involved in the financial reporting process; thus, the members of the audit committee should be held to a heightened standard of care. However, audit committees cannot be expected to undertake the same level of investigation as inside directors because of the members' independence.[133] To satisfy the duty of care applied to inside directors, the audit committee members essentially would become managers of the company by becoming involved in the daily operations of the company and focusing on every detail in an effort to avoid liability. When audit committee members become analogous to management, their independence is destroyed.[134] Thus, in reality, the structure of the audit committee makes it impracticable to hold audit committee members to a higher standard of care.

Another argument supporting a heightened standard of care is that because the audit committee members have access to the same information as the inside directors, they should be held to the same standard of care in analyzing that information. However, another structural limitation that the audit committee faces, and which some courts have addressed, is the fact that audit committees are not necessarily staffed with "financial experts." While an ideal audit committee would consist of directors with a high degree of financial literacy, not all corporations have the ability to recruit such directors.[135] Thus, it is impracticable for an audit committee member with limited financial knowledge and understanding to satisfy the higher standard of care normally applied to directors with intimate knowledge of the corporation's financial statements. Some courts that have addressed the issue of audit committee member liability have looked at the financial literacy of the audit committee as a

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133. *Supra* n. 28–29 and accompanying text. The NACD has stated that "[o]utside directors tend to have less intimate knowledge of corporate activities, so they are not expected to be responsible for the same level of personal involvement in corporate affairs as a full-time employee." Natl. Assn. Corp. Dirs., *supra* n. 3, at 28.

134. Olson, *supra* n. 16, at 1106 (warning that effective audit committee members cannot attempt to become full-time managers of the company).

135. *Id.*; *Millstein / Whitehead Report*, *supra* n. 3, at 12 (recommending that each director on the audit committee should be "financially literate . . . or become[] financially literate within a reasonable period of time" after appointment to the committee). However, in adopting new rules based on the Blue Ribbon Committee's recommendations, the SEC did not adopt a financial literacy requirement. SEC, *supra* n. 3. Further, in analyzing the Blue Ribbon Committee proposals, the Business Roundtable supported the idea of staffing audit committees with financially literate directors, but only as a best practice not a requirement. Barnette, *supra* n. 132, at 30.

factor in determining whether to apply a heightened standard of care.[136] However, even financial experts should not be held to a higher standard of care because of the functional and practical problems the audit committee confronts in attempting to satisfy such a standard.

B. Functional Problems

In addition to the structural problems that arise from applying a heightened standard of care to audit committee members, functional problems also arise. It is a well-founded principle in corporate governance that a corporation's board of directors should serve as a monitor and overseer of the company, whereas the officers should manage the company on a day-to-day basis.[137] As an extension of the board, the same principle lies for the audit committee. Again, the primary function of the audit committee is to monitor and oversee the company's internal reporting and control process.[138] Preparing financial statements and "micromanaging" the company are not audit committee duties.[139]

The audit committee relies on management for accurate and timely information to monitor and oversee the internal control process effectively.[140] Therefore, a prudent audit committee should

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136. *Tischler*, 801 F. Supp. at 1501 (considering the audit committee's "level of knowledge of the [corporation's] financial status" in holding the audit committee to a higher standard of care); *Bomarko, Inc.*, 848 F. Supp. at 1340 (noting that the audit committee members did not have any accounting expertise in rejecting a higher standard of care for the audit committee).

137. *See e.g.* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. Cin. L. Rev. 649, 652 (1995) (discussing the ways in which stock compensation for directors will motivate them to become more active monitors of management); Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 Cardozo L. Rev. 265, 269 (1997) (stating that "[r]ecent developments in corporate practice have emphasized the monitoring aspects of the board's role"); *Millstein / Whitehead Report*, *supra* n. 3, at 7 (stating that "the audit committee is an extension of the full board and hence the ultimate monitor of the process").

138. Knepper & Bailey, *supra* n. 13, at 9 (describing how the audit committee "implements and supports the board's oversight and monitoring functions"); *Millstein / Whitehead Report*, *supra* n. 3, at 7 (stating that "it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements"); Natl. Assn. Corp. Dirs., *supra* n. 3, at 5 (stating that one of the primary purposes of an audit committee is "to foster and oversee strong financial reporting and controls"). For a list of the different functions a typical audit committee performs, see *supra* notes 30 to 34 and accompanying text.

139. *Millstein / Whitehead Report*, *supra* n. 3, at 7.

140. *Id.* As a member of an audit committee of a financial institution, Eugene M. Katz remarks that an audit committee "must get the information . . . when it needs it, and must have the full confidence and respect of the internal audit staff and the independent auditors" to effectively do its job. Eugene M. Katz, *Characteristics of an Effective Audit Committee*, 115

spend its time focusing on the internal control system rather than conducting investigations similar to those performed by the inside directors.[141] Focusing on improving the internal control system will lead to better financial reporting and, ultimately, to more informed decisions on the part of the audit committee. Holding audit committees to a heightened standard of care creates the danger that the committee's focus will shift from oversight to active management. Audit committee members have neither the time nor the ability to participate in the active management of the company.[142] The members of the audit committee most likely have full-time jobs that severely limit the time they can devote to performing their duties effectively. Thus, holding audit committees to a heightened standard of care ignores the inherent functional limitations.

C. Discouragement of Qualified Directors

A third problem with a heightened standard of care arises when a board is attempting to recruit directors to serve on the audit committee. Although flattering, a request to join the board of directors can bring with it the dangers of potential liability and personal financial risk.[143] Even with the statutory protections that exist, lawsuits brought against directors generally have not decreased.[144] As a whole, companies are experiencing difficulty in recruiting qualified individuals to serve on the board because of the potential liability concern.[145] If outsiders are reluctant to serve on the board of directors, they will certainly be wary of accepting an invitation to join the company's audit committee.

Banking L.J. 37, 38 (1998); *see* Jonathan J. Lerner, *A Request to Join the Board*, 22 Dirs. & Bds. 32, 34 (Summer 1998) (advocating frequent interaction between management and the board for more effective monitoring).

141. Olson, *supra* n. 16, at 1106. In arguing that the audit committee members are not auditors, Olson states,

> If the audit committee attempts to master the obscurities of generally accepted accounting principles, or the detailed line item requirements of periodic reports filed with the SEC, there is a real danger that it will not take enough time to focus on the big picture issues it is uniquely qualified to address.

Id.

142. *Id.* at 1105 (explaining that audit committees meet three or four times a year and for a few hours each meeting).

143. Lerner, *supra* n. 140, at 32.

144. *Securities Fraud Litigation*, *supra* n. 6.

145. Lynne A. Whited, Student Author, *Corporate Directors —An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois*, 1987 U. Ill. L. Rev. 495, 495–496 (1987).

In determining that a higher standard of care for audit committee members is "not good public policy," the NACD has expressed concern regarding the possibility of discouraging directors from joining the committee.[146] The NACD stated that "[i]f the standard of care that is expected of audit committees reflects the imposition of unreasonable expectations on audit committee performance, then qualified directors may begin to shun audit committee membership."[147] Others share this view as well. Recently, an expert panel met to discuss ways to improve the oversight function performed by audit committees.[148] At this meeting, the chairman of the Independence Standards Board,[149] William T. Allen, expressed concern that increased responsibilities for the audit committee would discourage qualified directors from serving on the committee because of the potential increase in liability.[150] Even the SEC recognizes that additional liability could make it more difficult for a corporation to find qualified directors to serve on the audit committee.[151]

This potential problem is magnified by the courts' applying a heightened standard of care to audit committee members. By holding the audit committee to the same standard as the inside directors, the courts are effectively increasing the potential liability for audit committee members. If courts begin to follow this reasoning, well-informed directors, or potential directors, will choose not to subject themselves to the potentially devastating costs and damage to their reputation that accompany a lawsuit. Membership on the audit committee "must not be made so burdensome that only the otherwise idle or ill-advised will accept."[152]

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146. Natl. Assn. Corp. Dirs., *supra* n. 3, at 27–29.

147. *Id.* at 27.

148. *Panel Hears*, *supra* n. 17, at 12.

149. The Independence Standards Board was developed by the American Institute of Certified Public Accountants, the accounting profession, and the SEC for the purpose of "establishing and improving [auditors'] independence standards." Indep. Stands. Bd., *About the ISB* <http://www.cpaindependence.org/textview.php3?doc_id=whatdoes> (accessed Mar. 20, 2001).

150. *Panel Hears*, *supra* n. 17, at 12. According to chairman of the Independence Standards Board, William T. Allen, "the best way to bring more diligence and integrity to the work done by audit committees is to 'change attitudes.'" *Id.*

151. SEC, *supra* n. 8 (recognizing that "increased disclosure about audit committees may expose audit committee members to additional liability, [and] may make it more difficult for companies to find good people willing to serve on audit committees").

152. Olson, *supra* n. 16, at 1103.

D. Practical Problem: Will This Really Work?

A fourth argument against holding audit committee members to a heightened standard of care is that this tactic will not necessarily result in achieving the ultimate goal: more reliability and credibility in the financial reporting process. Scholars and practitioners alike have raised this argument, but it has not been developed.[153] Without any available empirical data on the effects that a heightened standard of care has on audit committee performance, the question is difficult to answer. However, in support of the argument that a heightened standard of care will not result in more effective audit committees and more reliable financial reporting, a comparison to the accounting profession can be made.

In 1992 the California Supreme Court examined the issue of auditors' liability to foreseeable third parties in *Bily v. Arthur Young and Company*.[154] The case involved a computer company, Osborne Computer Corporation (Osborne), and its auditors, Arthur Young and Company (Arthur Young).[155] Osborne was planning for an upcoming initial public offering and engaged Arthur Young to perform the audit on its 1981 and 1982 financial statements.[156] After completion of the audit, Arthur Young issued an unqualified opinion.[157] Following the audit, Osborne's public offering fell through and the company became insolvent.[158] Osborne had problems with its internal accounting procedures, and Arthur Young's audit revealed profits in 1982 when the company actually experienced over three million dollars in losses.[159] Consequently, the investors, which included individuals, pension funds, and venture capital

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153. Natl. Assn. Corp. Dirs., *supra* n. 3, at 27.

154. 834 P.2d 745 (Cal. 1992).

155. *Id.* at 747.

156. *Id.* The company was one of the fastest growing companies in American business history, because it developed the first portable computer for the mass market. *Id.*

157. *Id.* An unqualified opinion is rendered when the auditor "do[es] not have any exceptions, reservations, or qualifications that the financial statements present fairly the client's financial position, results of operations, and changes in financial position," but does not guarantee the financial statements. Julie Faussie, Student Author, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 Val. U. L. Rev. 1041, 1068 (1994).

158. *Bily*, 834 P.2d at 748. Following the audit, the company suffered a large drop-off in sales because of problems in manufacturing its new line of computers and competition from IBM. *Id.*

159. *Id.*

investment funds, sued Arthur Young for fraud, negligence, and negligent misrepresentation.[160]

The court ruled that an auditor is not liable to all foreseeable third-party users of audited financial statements for professional negligence.[161] In arriving at this decision, the court focused on three factors. The first factor was that the auditor is a "watchdog," and it is the client (company) that prepares the financial statements and is primarily responsible for the contents of those statements.[162] The court noted that the auditor cannot possibly become an expert in the company's line of business because of time constraints and that the audit report is "the final product of a complex process involving discretion and judgment on the part of the auditor at every stage."[163] The second factor considered was that the third parties that rely on audit opinions are sophisticated in financial matters; therefore, the third parties should use their own prudence and contracting ability to protect themselves.[164] Third, and most important for this comparison, the court rejected the argument that holding auditors liable to all third parties would promote accurate audits.[165] After reviewing the case law and commentary, the court noted that there was no empirical data that supports that argument, and it is doubtful "that a significant and desirable improvement in audit care would result from an expanded rule of liability."[166]

In fact, an increase in liability might result in auditors reducing their services to industries in which there is a high rate of business failure.[167] In fact, some accounting firms have reduced the amount

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160. *Id.* at 748–749.

161. *Id.* at 767.

162. *Id.* at 762 (citing *In re Interstate Hosiery Mills, Inc.*, 4 SEC 721 (SEC 1939)).

163. *Id.* (stating that "regardless of the efforts of the auditor, the client retains effective primary control of the financial reporting process").

164. *Id.* at 764. The court rejected the argument that the theory of products liability should apply and that the lack of privity between the auditors and third parties should not create a barrier to recovery for negligence. *Id.*

165. *Id.* at 765. In rejecting the argument, the California Supreme Court disagreed with the reasoning of the New Jersey Supreme Court in *Rosenblum v. Adler*, 461 A.2d 138, 152 (N.J. 1983), that increased liability would result in more thorough audits. *Bily*, 834 P.2d at 765.

166. *Bily*, 834 P.2d at 765.

167. *Id.* at 766. The court based its reasoning on the arguments against increasing auditors' liability found in Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 Brook. L. Rev. 1051, 1055 (1987). For a summary of Fischel's argument, see *infra* note 212 and accompanying text.

of clients and services to mitigate liability exposure.[168] Finally, the court stated that auditors might not be "the most efficient absorbers of the losses from inaccuracies in financial information."[169]

Although the audit committee members are not auditors, the court's reasoning in *Bily* can be applied to the audit committee. The first factor the court looked at in *Bily* is directly applicable to audit committees.[170] While the audit committee will know more about the particular business of its company than the external auditor, members of the audit committee cannot become experts in the financial reporting process, primarily because of time constraints.[171] The financial reporting process involves detailed and complex work on the part of management, the internal auditors, and the external auditors.[172] As monitors of this process, or "watchdogs," the audit committee members cannot involve themselves in the intricate details of the process without becoming full-time employees of the company or certified experts in accounting.[173]

Furthermore, the court rejected the argument that increasing auditors' liability will result in accurate audits.[174] The same argument can be made for audit committees. There is no empirical data that suggests applying a heightened standard of care will produce accurate financial reporting. The court in *Bily* seriously doubted that increased liability would produce better results.[175] This

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168. Scott Vick, Student Author, *Bily v. Arthur Young & Co.: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?*, 26 Loy. L.A. L. Rev. 1335, 1362 (1993) (citing a survey by Mark Nelson, *Risky Business: Professional Liability Exposure on the Rise*, Outlook 36, 37 (Fall 1990)).

169. *Bily*, 834 P.2d at 766 (arguing that by diversifying investments, investors and creditors may be better suited to absorb the loss than the auditors).

170. The second factor that the court looked at in *Bily*, whether certain third parties can recover from the auditors, is not relevant to this Comment, which is limited to a discussion on the standard of care for audit committee members. *Id.* at 764–765.

171. Olson, *supra* n. 16, at 1106. However, while time constraints limit the ability of the audit committee members to become "experts" in all aspects of the company, an effective audit committee will spend a significant amount of time outside the board room learning about the company and its business. This extra effort to learn the company will enable an audit committee member to monitor more effectively by knowing what questions to ask and where to go to get the answers. *Id.* at 1110.

172. *Id.* at 1106–1107 (stating that audit committees must rely on the skills of the internal and external auditors who report to them).

173. *Id.* at 1107; *supra* nn. 139–142 and accompanying text.

174. *Bily*, 834 P.2d at 765.

175. *Id.* (stating that a negative economic effect is just as likely to occur as increased performance by the auditors); *see* Fischel, *supra* n. 167, at 1055 (stating that "accountants will take steps that do not increase the quality of monitoring services but create a paper trail that is of value in litigation").

is similar to the position taken by the NACD in its "best practices" guide for audit committees.[176] Also, the court felt that increasing auditor liability might have a negative impact on the auditing profession.[177] Following the reasoning in *Bily*, applying a higher standard of care to the audit committee will cause directors to choose to avoid liability and not to serve on the committee. Consequently, the audit committee will be unable to recruit otherwise qualified directors. The committee must rely on management and the outside auditor to perform its job efficiently, and it is the full board that has the ultimate responsibility for the company's decisions.

V. RECENT DEVELOPMENTS REGARDING AUDIT COMMITTEES

In addition to questionable court decisions, there have been recent developments in the corporate community that directly involve audit committees and create additional concern for the liability of audit committee members. In 1999 alone, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees published its report and recommendations, the NACD headed its own Blue Ribbon Commission that published a practical guide for audit committees, and the SEC adopted final rules regarding audit committee disclosures, which became effective on January 31, 2000.[178] Although these sources have been cited extensively throughout this Comment, it is important to discuss separately the liability concerns arising from these developments in light of those cases that have treated audit committee members as inside directors.

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176. Natl. Assn. Corp. Dirs., *supra* n. 3, at 27 (stating that "it is questionable whether increasing liability risks will actually lead to more effective audit committee performance"); *see* Steve M. Samek & Joseph F. Berardino, *New Audit Committee Reforms*, 20 Corp. Bd. 8, 9 (May/June 1999) (stating that "accountability alone may not be enough to move audit committees to an optimal level of performance"). Audit committees are focusing more on overseeing management's process of identifying business risk and managing business risk than on financial reporting. Samek & Berardino, *supra* n. 176, at 9. Focusing on rules that increase accountability probably will not result in better performance by the audit committee. *Id.*

177. *Bily*, 834 P.2d at 766. In determining that increasing auditors' liability may have a negative impact on the profession, the court relied on an economic analysis. For a summary of this analysis, see *infra* notes 211 to 213 and accompanying text.

178. *Supra* n. 3 and accompanying text.

The Blue Ribbon Committee's report and recommendations received the most attention of the 1999 reports. Because of the abundance of literature analyzing this report[179] and the fact that the SEC has adopted rules based on the recommendations contained in the report, a detailed analysis is not necessary here. However, these recommendations represent the ideas of experts and scholars on how to improve audit committee effectiveness. Thus, a discussion of those recommendations that relate to the liability of audit committee members is necessary.

The Blue Ribbon Committee recommended that the audit committee provide disclosure of "the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements . . . ."[180] Furthermore, the Committee recommended that the audit committee disclose to the shareholders "whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter . . . ."[181] Most important, the Committee recommended that a letter from the audit committee be included in the Form 10K Annual Report and the annual report to shareholders, which says, in part, that "the audit committee, in reliance on the review and discussions conducted with management and the outside auditors . . . believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects."[182]

Although the Blue Ribbon Committee recommended requiring the audit committee to make more affirmative statements during the financial reporting process, it clearly stated that it was not its intention "that such additional disclosure requirements would impose greater liability on the audit committee . . . ."[183] Thus, the Blue Ribbon Committee recommended that the SEC adopt a safe harbor provision to protect against liability.[184]

These recommendations were not met with open arms. Some believed that the Committee was focusing on the less important

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179. *E.g. Attention*, *supra* n. 4, at 128; Olson, *supra* n. 16, at 1097–1100; Harvey L. Pitt et al., *Tough Standards for Audit Committees: The Report of the "Blue Ribbon" Committee*, 1134 P.L.I. Corp. L. & Prac. Course Handbook Series 527, 529 (Aug. 1999); Samek & Berardino, *supra* n. 176, at 8–12.

180. *Millstein / Whitehead Report*, *supra* n. 3, at 13.

181. *Id.*

182. *Id.* at 16.

183. *Id.* at 27.

184. *Id.*

issue, the financial aspects of the audit committee, instead of the more important issue concerning independent directors and their ability to learn about what is going on in the company.[185] Others believed that the recommendations would lead to an increase in liability risks for audit committee members instead of actually increasing audit committee effectiveness.[186] The increased risk of liability would arise in securities fraud claims.[187] This would occur because the mandatory disclosure would "provide a reasonable basis for specific allegations of audit committee responsibility for financial reporting failures."[188] In light of the potential increased legal exposure as a result of courts holding audit committees to a higher standard of care, the Blue Ribbon Committee recommendations discussed would create additional ways in which a court could impose liability on the audit committee. However, not all of the Blue Ribbon Committee's recommendations were adopted by the SEC, and some were altered as a result of negative responses by the corporate community concerned about increasing audit committee member liability.[189]

The second recent development affecting corporate audit committees was the publication of the *Report of the NACD Blue Ribbon Commission on Audit Committees, A Practical Guide*.[190] Of the reports analyzed, this report is the most comprehensive and practical approach to improving the effectiveness of audit committees, with the ultimate goal of increasing the accuracy and credibility of the financial reporting process. In contrast to the Blue Ribbon

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185. Lorne, *supra* n. 129, at 505.

186. Pitt et al., *supra* n. 179, at 529. Although there were no arguments against the Blue Ribbon Committee's goal of increasing audit committee effectiveness, directors, officers, and professionals were concerned "that the Report impose[d] unnecessary burdens on the financial reporting process and that adherence to its recommendations would lead to increased liability risks for members of audit committees." *Id.*

187. 15 U.S.C. § 78u-4(b)(1) (1994). Requiring audit committees to make affirmative statements enables a plaintiff to point to specific statements of the audit committee to satisfy the statutory pleading requirements.

> In a private action against a defendant where plaintiff claims defendant made either an untrue statement or omitted to state a material fact necessary to make the statement not misleading "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."

Id.

188. Olson, *supra* n. 16, at 1105.

189. *Infra* nn. 196–200 and accompanying text.

190. Natl. Assn. Corp. Dirs., *supra* n. 3.

Committee approach of imposing more rules and requirements on the audit committee, the NACD approaches the problem with a list of "best practices" that audit committees should use as a guide for improving their effectiveness.[191] The NACD begins the report by making the following four important observations:

> [1] The audit committee should focus its attention and tailor its responsibilities appropriately, according to the company-specific environment. Audit committee members should not be overloaded with tasks or they may lose sight of the big picture.
>
> [2] The ultimate governance body in any corporation is the board of directors. The role of the audit committee cannot and should not be allowed to supersede that of the board.
>
> [3] Without the explicit support of the entire board and management, the audit committee will have difficulty being fully effective.
>
> [4] A good audit committee is not a cure-all and cannot guarantee prevention of fraud or failure.[192]

These observations support the NACD's approach to improving the effectiveness of audit committees, and ultimately the reliability of the financial reporting process, which is to focus on the corporation and board of directors as a whole, rather than single out the audit committee by applying higher standards of care.

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191. *Id.* at vii.

192. *Id.* These observations can be applied to the audit committee members at XYZ Corporation (XYZ). Suppose that XYZ is located in a jurisdiction where the courts have held audit committee members to a higher standard of care. The inside directors at XYZ were aware that the company was materially overstating its assets, and they had not disclosed this information to the full board. During the period that XYZ was overstating its assets, the audit committee, concerned about the higher standard of care, became engulfed in the minute details and day-to-day decisions involving the financial reporting process. As a result, the audit committee did not detect the problem.

In this example, it becomes clear that the NACD observations are important because they further support the argument that the audit committee is not capable of preventing financial statement fraud, and it should not be subject to a higher standard of care to achieve better financial reporting. The audit committee at XYZ lost sight of the big picture in an attempt to satisfy the higher standard of care normally applied to inside directors. Further, the inside directors of XYZ were involved in the fraud. Consequently, the audit committee could not function effectively, because there was no support from the full board. Finally, although the audit committee diligently worked to meet the higher standard of care, it could not prevent the fraud from occurring.

Also, in contrast to the Blue Ribbon Committee, the NACD placed considerable emphasis on the problems with increasing the audit committee's exposure to liability.[193] The NACD expressed particular concern that the increased reliance on audit committees may result in standards that are higher than other board committees.[194] The NACD recognized the inherent problems an audit committee would face in attempting to satisfy a heightened standard of care and contends that the audit committee members should be held to the ordinary standard of care.[195] Although, in this Author's opinion, the NACD approach would produce the best results, the Blue Ribbon Committee recommendations formed the basis for the newly adopted SEC rules.

Based primarily on the recommendations of the Blue Ribbon Committee, the SEC adopted the new rules regarding audit committees, which took effect on January 31, 2000.[196] The SEC recognized there were liability concerns with requiring the audit committee to certify the financial statements, and it modified the proposed rule before its adoption.[197] The proposed rule followed the Blue Ribbon Committee's recommendation that the audit committee certify whether the financial statements conformed to Generally Accepted Accounting Principles (GAAP).[198] The new rule will "require that the report of the audit committee also include a statement by the audit committee whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB . . . ."[199] Also, the SEC adopted a safe harbor provision to protect further the

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193. *Id.* at 27–29.

194. *Id.* at 27–28.

195. *Id.* at 28–29. The NACD believes that a "'reasonable person' business judgement approach is the right standard for audit committees." *Id.* at 28.

196. The new rules and amendments are codified at 17 C.F.R. §§ 210.10–01, 228.306, 228.310, 240.14a–101, 229.302, 229.306 (2000).

197. SEC, *supra* n. 3.

198. SEC, *supra* n. 8.

199. SEC, *supra* n. 3; *see* 17 C.F.R. §§ 228.306, 229.306 (codifying the final rule). Olson remarked that the proposed rule had raised serious concerns among audit committee members, and the new rule will help increase "the comfort level of audit committee members and the lawyers who advise them." *Audit Committees' Actions, Independence to Face Greater Scrutiny under SEC Rules*, 3 Corp. Governance Rep. 1, 2 (Jan. 3, 2000).

audit committee members from liability while still promoting the goal of improved financial reporting.[200]

Because the rules have just recently become effective, their effect on the liability of audit committee members has yet to be seen. However, these rules may lead to the same problems as could result from a higher standard of care for audit committees. For example, the increased scrutiny will raise structural and functional problems by causing audit committee members to increase their involvement in the daily operations of the company to avoid exposure to liability. Another potential problem with the adopted rules is that they "could discourage otherwise well-qualified people from serving on corporate boards . . . ."[201] This is identical to the problem of discouraging qualified directors from serving on the audit committee, because some courts held the audit committee members to a higher standard of care.[202] Furthermore, although these disclosures and procedures adopted by the SEC are good ideas in theory, "the procedures become checklists to avoid litigation, as opposed to procedures that create a process based on integrity."[203] This view relates back to the practical problems presented by holding audit committee members to a higher standard of care. Will these rules actually promote investor confidence and lead to accurate financial reporting? Is targeting the audit committee the best way to attack the problems with the financial reporting process?[204] In sum, the aforementioned developments have increased significantly the attention given to

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200. SEC, *supra* n. 3. Under the adopted safe harbor provision, the required additional disclosures would not be considered "soliciting material" for purposes of Regulation 14A or 14C and would not be subject to the liabilities of Section 18 of the Securities Exchange Act unless specifically requested that the disclosures be considered soliciting material. This means that additional disclosures will not subject the audit committee to liability under the solicitation of proxy rules in Section 14 of the Exchange Act or the liability for misleading statement rules in Section 18 of the Exchange Act. However, the SEC did not provide a safe harbor from private litigation because the new rules are not intended to increase the exposure of the audit committee member to liability or to impose new standards. *Id.*

201. *Panel Hears*, *supra* n. 17, at 12.

202. *Tischler*, 801 F. Supp. at 1501; *Greenfield*, 677 F. Supp. at 115; *In re MTC Elec. Techs.*, 898 F. Supp. at 980; *In re JWP Inc.*, 928 F. Supp. at 1260; *In re AM Intl.*, 606 F. Supp. at 605.

203. *Panel's Proposals*, *supra* n. 16, at 97 (quoting comments by Charles M. Elson, professor of law and corporate director).

204. In a recent panel discussing the recommendations of the Blue Ribbon Committee, A.A. Sommer Jr., a partner at the Washington, D.C. law firm of Morgan, Lewis & Bockius, remarked that formal rules have not been imposed on audit committees in the past. He stated that "[a]udit committees mostly have benefited from jawboning about best practices, advice from auditors, advice from experts, and all of a sudden we are introducing a much more compelling force to drive audit committees and their function." *Id.* at 98.

corporate audit committees. Most important there are now new rules requiring audit committees to make several disclosures in the company's annual financial reports.[205] Although the SEC modified the most controversial proposed rule because of a concern for increased liability, adding more affirmative statements to the proxy statements will serve as an additional basis for shareholders to bring suit. At a time when securities class action suits are increasing, these statements by the audit committee will increase the potential that it will be subject to liability.[206] Combining these risks with the cases holding audit committee members to a higher standard of care creates a serious threat of increasing the audit committee's exposure to litigation in the future.

VI. IS THERE A BETTER WAY?

After determining that a heightened standard of care for audit committee members is not the best way to achieve accurate financial reporting, the question then becomes whether there is a better way to achieve the desired goal of investor confidence in accurate and reliable financial reporting. This is a problem for which there are no easy answers.

One possible method for improving financial reporting that has not been raised by many scholars and practitioners is to have the audit committee hire an outside professional, such as a certified public accountant, to examine the company's internal control system.[207] These outside professionals can then give recommendations on any weaknesses or problems they encounter.[208] This method could also help reduce liability in the face of litigation, because it could demonstrate that the audit committee performed its duty to act with reasonable care.[209] However, this suggestion was not mentioned in either the Blue Ribbon Committee's report and recommendations or the NACD's practical guide. It is possible that this concept has not materialized, because the outside professional would essentially be simply another independent outside auditor. Instead of hiring outside professionals, these reports recommended

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205. SEC, *supra* n. 3.

206. *See Securities Fraud Litigation, supra* n. 6 (noting the increase in class action securities fraud litigation).

207. Pastuszenski & O'Connor, *supra* n. 1, at 16.

208. *Id.*

209. *Id.* at 16–17.

that the audit committee members (at least some of them) should acquire a certain degree of financial literacy.[210]

Another approach to improving financial reporting is to increase the liability of the outside auditors rather than that of the audit committee. After all, the outside auditors are hired to be experts in reading and interpreting financial statements and in evaluating the internal control systems of a company. Further, increasing the auditor's liability will encourage better performance. However, cases such as *Bily* have demonstrated a desire, at least by some courts, to limit the liability of the outside auditors.[211] Another problem is the possibility that the auditors will merely take steps to create a paper trail to protect themselves during litigation, rather than taking steps to improve their monitoring services.[212] This approach is not the best solution, because it merely shifts the liability from the audit committee to the auditors even though management is the entity responsible for supplying the audit committee and the auditors with accurate information.[213] Like the audit committee, the auditors do not guarantee the reliability of the financial statements.[214] The auditors follow their professional standards, just as the audit committee follows the standard of care for directors.[215] As the court in *Bily* stated, increased liability will not necessarily result in increased performance.[216] Therefore, increasing liability for auditors

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210. *Millstein / Whitehead Report*, *supra* n. 3, at 12; Natl. Assn. Corp. Dirs., *supra* n. 3, at 10–11.

211. 834 P.2d at 767.

212. Fischel, *supra* n. 167, at 1055. Fischel approaches the issue of increasing liability for independent accountants from an economic viewpoint. *Id.* He reasons that

> [t]he deterrent effect of liability rules is the difference between the probability of incurring liability when performance meets the required standard and the probability of incurring liability when performance is below the required standard. Thus, *the stronger is the probability that liability will be incurred when performance is adequate, the weaker is the deterrent effect of liability rules.*

Id. (emphasis added). The court in *Bily* applied this argument in its decision to limit liability for independent accountants to foreseeable third parties. *Bily*, 834 P.2d at 767.

213. *Millstein / Whitehead Report*, *supra* n. 3, at 7; *supra* nn. 139–140 and accompanying text.

214. Goldstein & Dixon, *supra* n. 35, at 441 (explaining that the company itself is primarily responsible for the financial statements, and that the auditors provide reasonable assurance to the public that the financial statements conform to the GAAP).

215. Auditors must follow the professional standards known as generally accepted accounting principles established by the American Institute of Certified Public Accountants in performing the audit. David A. Jaffe, Student Author, *The Allocation of Fault in Auditor Liability Lawsuits Brought by Sophisticated Third Party Users of Financial Statements — A Plea for Proportionate Liability*, 54 U. Pitt. L. Rev. 1051, 1055 (1993).

216. 834 P.2d at 765.

is not the way to improve financial reporting. This approach will merely shift the blame to another party without achieving the desired results.

A better approach would be to attack the problem at its source. The financial statements are generated within the company. Therefore, to increase the credibility of the financial reporting system, changes need to be made from within the corporate entity. In Chairman Arthur Levitt's recent speech at the New York University Center for Business and Law, the SEC called for a "fundamental cultural change on the part of corporate management as well as the whole financial community" to deal with the current problems of earnings management and to improve the credibility and transparency of financial reporting.[217] This idea of changing the culture of corporate management is an idea that the NACD would probably support.

In its practical guide for audit committees, the NACD suggests that "[a]udit committees should encourage a 'tone at the top' that conveys basic values of ethical integrity as well as legal compliance and strong financial reporting and control."[218] The NACD noted that the tone set by management "is the most important factor contributing to the integrity of the financial reporting process."[219] Thus, rather than focusing on the details of reports and disclosure documents and conducting procedures that are merely "checklists to avoid litigation," the audit committee should focus on the quality of the company's internal control system.[220] Because the financial reports are generated through the internal processes of the company, focusing on improving those processes will lead to reliable financial reporting.[221] This approach seems to achieve the goal of accurate financial reporting more effectively than the other approaches. Rather than shifting the blame to different parties, this approach starts at the source of the problem, management and the internal control system of the company, and encourages a collaborative effort to effectuate an overall change in the company's culture.

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217. Arthur Levitt, *supra* n. 8. The problems discussed were "'big-bath' restructuring charges, creative acquisition accounting, 'cookie jar reserves,' 'immaterial' misapplications of accounting principles, and the premature recognition of revenue." *Id.*

218. Natl. Assn. Corp. Dirs., *supra* n. 3, at 20.

219. *Id.*

220. *Panel's Proposals*, *supra* n. 16, at 97.

221. Olson, *supra* n. 16, at 1109 (noting that superior audit committees emphasize the company's internal controls); *Panel's Proposals*, *supra* n. 16, at 97–98 (stating that the "best approach for getting good financial integrity and reporting is by using best accounting practices").

VII. HOW CAN AUDIT COMMITTEE MEMBERS PROTECT THEMSELVES?

In light of this discussion on the problems with holding audit committee members to a heightened standard of care and the potential increased exposure to liability that the audit committee faces, are there ways that the audit committee members can protect themselves? In the hypothetical presented at the beginning of this Comment, what could the audit committee members of XYZ have done to minimize their exposure to liability in the upcoming lawsuit?

There are four ways in which the corporation can limit the audit committee members' exposure to liability.[222] First, some states allow a corporation to include in its certificate of incorporation a provision to limit the personal liability of a director for a breach of the duty of care.[223] However, these statutes do not provide protection against federal securities law violations.[224] Therefore, in the lawsuit against the audit committee of XYZ, this protection would not be available. Nonetheless, these statutes can limit a judgment against a director, which in some cases can be financially devastating. Second, states also have corporate indemnification statutes to indemnify directors against expenses, attorneys' fees, judgments, and fines.[225] These statutes do not provide indemnification for directors acting in bad

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222. For more recommendations on limiting the liability exposure of audit committees, see Pastuszenski & O'Connor, *supra* n. 1, at 15 (providing a list of "Top Ten Audit Committee Lifesavers") and Reinstein et al., *supra* n. 26, at 702–703 (listing twelve recommendations to reduce potential liability).

223. *E.g.* Del. Code Ann. tit. 8, § 102(b)(7) (1994) (providing that a corporation may include "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director"); N.Y. Bus. Corp. Laws § 402(b) (McKinney Supp. 2000) (providing that a corporation "may set forth a provision eliminating or limiting the personal liability of directors to the corporation or its shareholders for damages for any breach of duty in such capacity"). However, these statutes do not provide protection against a breach of the duty of loyalty or knowing violations of the law. Del. Code Ann. tit. 8, § 102(b)(7) (1994); N.Y. Bus. Corp. Laws § 402(b)(1) (McKinney Supp. 2000).

224. Lerner, *supra* n. 140, at 35.

225. *E.g.* Del. Code Ann. tit. 8, § 145(a) (Supp. 1998) (providing that a corporation has the power to indemnify directors "against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred"); N.Y. Bus. Corp. Laws § 722(a) (McKinney Supp. 2000) (providing that a corporation may indemnify a director "against judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees actually and necessarily incurred").

faith.[226] Therefore, as the facts of the XYZ hypothetical do not indicate bad faith, this protection would be available. Furthermore, audit committee members should inquire about forming an indemnification contract with the corporation in addition to the statutory provisions.[227]

The third common method for protecting against liability is through directors and officers (D&O) insurance. The corporation should provide adequate D&O insurance. Described as "the ultimate barrier to personal financial exposure," D&O insurance is the most important of the four methods of protection.[228] As compared to indemnification provisions, D&O insurance is a more reliable protection, because it is not limited to the company's financial ability to pay.[229] However, there have been recent concerns about D&O insurance coverage when directors are sued for misrepresentations or financial statement fraud.[230] Some insurance carriers have denied coverage or taken reservations to coverage when the fraud occurs before an initial application for coverage or before a renewal of coverage.[231] Thus, audit committee members are not necessarily guaranteed coverage under D&O insurance.

Finally, a fourth method in which the audit committee members of XYZ could have protected themselves from liability is by seeking advancement of legal fees and expenses from the corporation.[232] However, advancement is usually a discretionary decision on the part of the corporation.[233]

Although statutory limitations, indemnification, D&O insurance, and advancement are important ways to limit liability and should be utilized, the best way to protect against liability is to avoid litigation. Thus, in addition to the four methods of protection described above, the audit committee at XYZ could reduce the threat of liability by following the "best practices" developed by the NACD.

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226. *E.g.* Del. Code Ann. tit. 8, § 145)(a) (stating that indemnification is available "if [the director] acted in good faith"); N.Y. Bus. Corp. Laws § 722(a) (stating that the corporation may indemnify "if [the] director . . . acted[,] in good faith").

227. Lerner, *supra* n. 140, at 35.

228. *Id.*

229. *Id.*

230. Natl. Assn. Corp. Dirs., *supra* n. 3, at 29; Olson, *supra* n. 16, at 1105.

231. Olson, *supra* n. 16, at 1105.

232. Lerner, *supra* n. 140, at 35. "Advancement" refers to the practice of advancing legal fees to directors while a case is pending. *Id.*

233. *Id.*

VIII. CONCLUSION

An effective corporate audit committee plays a vital role in the efforts to achieve an accurate and reliable financial reporting process. Holding audit committee members to a heightened standard of care will only deter the recent efforts to maximize the effectiveness of the audit committee. The recent focus on audit committees has created great concern over the future liability exposure for its members. Courts must recognize the inherent limitations in the audit committee that make a heightened standard of care impracticable. Applying the ordinary standard of care to audit committee members, such as those at XYZ Corporation, will protect directors who fulfill their duties diligently.