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The Sarbanes-Oxley Act: How a Current Model in the Law of Unintended Consequences May Affect Securities Litigation

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I. INTRODUCTION

As a result of highly publicized incidents of corporate malfeasance, President George W. Bush signed the Sarbanes-Oxley Act on July 30, 2002, in an effort to rectify the public disclosure and accounting practice problems brought to light in the preceding ten months. Upon signing Sarbanes-Oxley into law, President Bush characterized the legislation as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." According to legislators, the Act's purpose is to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws." On its face, Sarbanes-Oxley (hereinafter "SOX" or "Act") succeeds in tackling major issues revealed during the corporate scandals through the implementation of governance policies, enhanced financial disclosures, heightened professional responsibility for attorneys and research analysts, as well as auditor independence.

SOX is more appropriately characterized as a legislative backlash to the extraordinary amount of serious financial disclosure and reporting transgressions, as well as corporate governance improprieties, which were publicly disclosed in 2001 and 2002. The Act alters reporting and disclosure regulations for public companies, increases criminal and civil liability for securities fraud, requires Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) to certify to their company's internal control proce-
dures, and it also prohibits personal loans from a corporation to its directors and officers.\(^6\)

SOX was certainly enacted in the spirit of reform and the provisions, literally read, appear to embody the changes to securities laws sought by legislators. However, speculation as to the Act's practical effects began rumbling throughout the legal community almost immediately after its enactment.\(^7\) Critics have deemed the Act an "illusion of increased accountability"\(^8\) and "a mere bandage for the wound of corporate fraud in America."\(^9\)

A. Economic Landscape Preceding the Enactment of Sarbanes-Oxley

The corporate breakdown and subsequent enactment of SOX were directly preceded by the "telecom/dot.com infused bubble of the late 1990's."\(^10\) During this period, the economy was booming. With this boom came millions of inexperienced investors to the stock market and, unfortunately, people to Wall Street who left much to be desired in terms of corporate ethics.\(^11\) Obviously, this was a dangerous mix. All of this occurred while stock prices were at all time highs and sixty percent of the financial holdings of American households were in equity investments.\(^12\)

When the telecom/dot.com bubble burst in March 2000, stock indexes began a rapid descent.\(^13\) Problems of the technological sphere soon spread to the once venerable corporations, causing

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\(^7\) Sorin et al., supra note 2, at 975.

\(^8\) Id. The authors believe that Sarbanes-Oxley "does nothing to provide restitution to shareholders who have lost their investments and retirement resources as a result of the recent scandals." Id.


\(^10\) Cunningham, supra note 6, at 923. Cunningham elaborates by stating that the "late 1990's period of economic expansion and technological innovation was of a magnitude that comes once a generation." Id.

\(^11\) Id.

\(^12\) David Rynecki, Stock Trading Nears Frenetic Pace of '29 Crash, USA TODAY, Feb. 23, 1999, at B1; Edward Hyatt, Share of Wealth in Stock Holding Hits 50 Year High, N.Y. TIMES, Feb. 11, 1998, at A1; William S. Lerach, Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders, 8 STAN. J.L. & FIN. 69, 70 (2002). Moreover, "individual and institutional investors increased their exposure to the markets to the highest levels since September 1929." Id. at 70.

\(^13\) Cunningham, supra note 6, at 923.
colossal declines in the market.\textsuperscript{14} Next came the unimaginable – September 11, 2001, a heart-wrenching event striking at the center of America's financial and political capitals. September 11th "jolted the markets and caused enormous economic and political uncertainties."\textsuperscript{15} Then, the Enron debauchery began in late 2001, reaching its boiling point in early 2002.\textsuperscript{16}

\section*{B. Legal Landscape Preceding the Enactment of Sarbanes-Oxley}

Before addressing the corporate scandals, which were the genesis of SOX, it is important to summarily note the surrounding legal landscape which preceded those scandals. Recognizing the legal context in which SOX was enacted is necessary for two primary reasons. First, SOX was not enacted in a vacuum; securities transactions occur in a heavily regulated forum. Therefore, other statutes, rules, regulations, and caselaw will affect the Act's application. Second, in the context of securities litigation, the various other sources of securities law will be vital in the interpretation of SOX because the legislation will be used in conjunction with, rather than as an alternative to, other sources of securities law.

SEC Rule 10(b)-5\textsuperscript{17} (hereinafter "10b-5") plays a vital role in securities fraud litigation.\textsuperscript{18} 10b-5 was created pursuant to section 10(b) of the Securities Exchange Act of 1934.\textsuperscript{19} In 1942, the SEC promulgated Rule 10b-5, known as a "utilitarian anti-fraud remedy"\textsuperscript{20} which prohibits fraud "in connection with the purchase or sale of a security."\textsuperscript{21}

\begin{itemize}
\item \textsuperscript{14} William S. Lerach, Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders, 8 STAN. J. L. & FIN. 69, 70 (2002).
\item \textsuperscript{15} Cunningham, supra note 6, 923-24.
\item \textsuperscript{16} For detailed analysis of the events surrounding the Enron Corporation in 2001 and 2002, see Cunningham, supra note 6, at 924.
\item \textsuperscript{17} 17 C.F.R. § 240.10b-5.
\item \textsuperscript{18} BLOOMENTHAL, HAROLD S. & SAMUEL WOLFF, SECURITIES & FEDERAL CORPORATE LAW § 13:1 (2d ed. 2003).
\item \textsuperscript{20} BLOOMENTHAL, supra note 18, at §13:1.
\begin{itemize}
\item It shall be unlawful for any person, directly or indirectly . . .
\item (1) to employ any device, scheme, or artifice to defraud,
\item (2) to make any untrue statement of material fact or 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
\item (3) 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.
\end{itemize}
\end{itemize}
The Private Securities Litigation Reform Act\textsuperscript{22} (PSLRA) was enacted in 1995, overriding the veto of President Clinton. The PSLRA instituted a strict pleading standard\textsuperscript{23} under which plaintiffs must "state with particularity facts giving rise to a strong inference" that defendant(s) acted with the "requisite state of mind."\textsuperscript{24} To that end, PSLRA procedural barriers override the usually applicable Federal Rules of Civil Procedure which requires only "notice" pleading.\textsuperscript{25} The purpose of the PSLRA was to deter what was labeled as frivolous securities fraud lawsuits of private plaintiffs, partly by instituting the higher pleading standard.\textsuperscript{26} Congressional intent underlying the enactment of PSLRA was also brought about, in part, by a desire to increase the difficulty of pleading and proving private securities fraud actions against individuals outside the management control group.\textsuperscript{27}

PSLRA's application is primarily focused on the 10b-5 actions of private plaintiffs.\textsuperscript{28} As a result, in an action alleging a violation of 10b-5, failure to properly plead the scienter requirement subjects plaintiffs to motions to dismiss, which pursuant to the PSLRA, stays discovery.\textsuperscript{29} In terms of the application of PSLRA to allegations of 10b-5 violations, the trend seems to be that recklessness constitutes a sufficient showing of scienter.\textsuperscript{30} The PSLRA contains a circular deficiency in that it requires pleadings that state facts with particularity, which can be an impossible task without the aid of discovery.\textsuperscript{31} However, under the PSLRA, discovery is stayed until the complaint states facts with particularity.

23. Cunningham, supra note 6, at 939.
26. Cunningham, supra note 6, at 939.
27. SCHULMAN ET AL., supra note 9, at 286.
28. BLOOMENTHAL, supra note 18, at §13:1. Specifically, "[t]he race to the courthouse by lawyers to file class actions upon the announcement of bad news resulting in a sharp decline of the market price of the company's stock provided much of the impetus for the PSLRA and such private actions are based almost exclusively on alleged violations of Rule 10b-5." Id.
29. BLOOMENTHAL, supra note 18, at §13:1.
30. SCHULMAN ET AL., supra note 9, at 289. For cases holding that recklessness satisfies the scienter requirement of Rule 10(b)-5 actions, see, e.g., In re Advanta, 180 F.3d 525 (3d Cir. 1999); Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000); In re Comshare, 183 F.3d 542 (6th Cir. 1999).
Beyond instituting a heightened pleading standard, PSLRA disallowed joint and several liability, replacing it with proportionate liability, and adopted a protective safe harbor period for "forward looking" information. The final blow to securities fraud plaintiffs came with the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which abolished class actions for securities fraud instituted in state courts.

The Supreme Court's decision in Cent. Bank of Denver, N.A., v. First Interstate Bank of Denver, N.A., held that liability for violations of federal securities laws shall be imposed only upon primary violators, to the exclusion of aiding abetting liability for secondary actors such as attorneys, accountants, and auditors, who in some manner facilitate the fraud. Further, in 1999, Congress repealed important aspects of the Banking Act of 1933 (Glass-Steagall Act), namely the "strict separation of the commercial and investment banking industries" contained in Glass-Steagall. Under the Banking Act, commercial banks collected deposits, extended credit, and serviced corporate customers, while investment banks underwrote the public offerings of securities. The Gramm-Leach-Bliley Financial Modernization Act of 1999 removed many of the former barriers between the two industries creating potential conflicts of interest in that the same bank may now engage in a commercial relationship with a corporate customer and also sell its securities to a public market.

33. 15 U.S.C. § 78u-4(f)(2)(b) (1997). It should be noted that the foundation for a 10(b)-5 action often stems from projections or other forward looking statements concerning a company's securities and those statements are then alleged to be false or misleading. BLOOMENTHAL, supra note 18, at §13:1. Thus, the PSLRA "safe harbor" is implicated in all such cases. BLOOMENTHAL, supra note 18, at §13:1.
34. John C. Coffee, Understanding Enron: It's About the Gatekeepers, Stupid. 57 BUS. LAW 1403, 1409-10 (2002).
36. §101, 112 Stat. at 3228.
38. Coffee, supra note 33, at 1409 (proposing the potential for laxity among gatekeepers such as lawyers, accountants, auditors where they are aware that they have no personal liability at stake).
40. Cunningham, supra note 6, at 940.
42. Cunningham, supra note 6, at 940.
44. Cunningham, supra note 6, at 940.
C. Corporate Malfeasance Incites Legislative "Reform"

During the beginning of the new millennium, America was fraught with tales of corporate wrongdoing; ranging from accounting fraud and corporate governance laxity to startling abuses of corporate loan programs by directors and officers. The collective breakdown resulted in plummeting stock prices, investigations by the Securities Exchange Commission (SEC), and massive corporate bankruptcies.\(^{45}\)

The first major scandal involved Enron, a world leader in providing energy sources, commodities, and related services.\(^{46}\) Through a lattice-work of suspect accounting methods and flat out fraud, Enron moved billions of dollars in debt off its balance sheet into a system of complex partnerships.\(^{47}\) The company's auditor, the then prominent accounting firm of Arthur Anderson, signed off on many of the transactions.\(^{48}\)

In late 2001, Enron disclosed that the company would sustain losses of up to $1 billion and would have to restate financial records from 1997 through the second quarter of 2001 in order to clear up errors and irregularities that had inflated its net income by more than $500 million.\(^{49}\) Especially disconcerting were a number of related party transactions between Enron and partnerships it had created wherein Enron's senior executives held substantial interests.\(^{50}\) These related party transactions were not disclosed on balance sheets, and Enron's interest in the partnerships was so substantial that they should have been treated as consolidated entities, rather than minority investments. Once the restatements occurred, Enron's stock price dropped by over ninety percent, and on December 2, 2001, the company filed for Chapter 11 bankruptcy protection.\(^{51}\) At the time, Enron's bankruptcy filing


\(^{46}\) Schulman et al., supra note 9, at 297. Some of Enron's business activities included the marketing of electricity and natural gas, delivering energy and physical commodities, and providing financial and risk management services. Id.


\(^{48}\) Id. at 297; Kranhold et al., Following the Trial: As Enron Inquiry Intensifies, Midlevel Players Face Spotlight, Wall St. J., April 30, 2002, at A1.

\(^{49}\) Schulman et al., supra note 9, at 298.

\(^{50}\) Cunningham, supra note 6, at 929.

\(^{51}\) Schulman et al., supra note 9, at 298.
was the largest in United States history and listed over $13 billion in debt. Arthur Anderson, Enron's outside auditor, with an eye towards its own involvement in the scandal, began destroying documents that could have evidenced wrongdoing at a fevered pace. The firm was later indicted and convicted of obstruction of justice as a result of the document destruction. By May 2002, the Enron debacle incited Congressional hearings and various reform bills as the country began what SEC Chairman Harvey Pitt called "an incredible journey to modernize securities regulation." The Enron scandal gripped the media's attention for sometime. However, the story began to fade as issues concerning accounting and disclosure transgressions, insiders' apparent conflicts of interest and breaches of fiduciary duties, huge revenue declines, and insider trading were exposed at some of America's most prominent corporations.

Global Crossing provided telecommunication services through 100,000 miles of fiber optic network. As was common in the telecommunications industry, Global Crossing engaged in capacity swaps with other telecommunications companies wherein companies would buy and sell rights to use each others fiber capacities. There were many instances where Global Crossing sold its fiber rights in the last two days of the second quarter in an effort to increase the company's stated revenues.

Much of Global Crossing's inflated profits were attributed to the use of *pro forma* reporting, a technique that tends to conceal many expenses that otherwise appear on the balance sheet when Gener-

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53. Cunningham, supra note 6, at 929.

54. BLOOMENTHAL, supra note 51, at § 1. For a more detailed discussion of Arthur Anderson's involvement in the Enron scandal, see HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE, § 5 (2002).

55. BLOOMENTHAL, supra note 51, at § 1; Michael Schroeder & Greg Hitt, Accounting Industry Is Taken to Task, WALL ST. J. (Online ed.), Mar. 8, 2002.

56. BLOOMENTHAL, supra note 51, at § 1.


58. SCHULMAN ET AL., supra note 9, at 298-99.

ally Accepted Accounting Principles (GAAP) are used. Further, the company’s outside auditor, Arthur Anderson, signed off on annual reports which utilized the pro forma method. In 2001, Global Crossing’s Chairman, Gary Winnick, unloaded more than $100 million worth of stock claiming that he had no knowledge of Global Crossing’s substantial revenue declines.

In January 2002, Global Crossing filed for Chapter 11 bankruptcy protection. Congressional concern over conduct exhibited during the Global Crossing scandal probably influenced the creation of the Public Oversight Accounting Board in SOX. The Board’s stated purpose is “[t]o oversee the audit of public companies that are subject to securities laws . . . in order to protect the interests of investors and further public interest in the preparation of informative, accurate, and independent audit reports.”

Like Global Crossing, WorldCom was also a global communications giant. Initially, attention was focused on WorldCom’s accounting procedures when an internal audit revealed $500 million in fraudulent expenses. Further investigation resulted in the discovery of substantial accounting irregularities. The revelations of accounting impropriety at WorldCom was even more astounding because the fraud perpetrated was elementarily simple and had not involved a complex scheme as in the Enron case.

WorldCom inflated its profits in the amount of $3.8 billion by treating the payments it had made for the use of other companies’ lines, which are appropriately treated as operating expenses, as capital expenditures. When properly accounted for, the line use

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60. Cunningham, supra note 6, at 930. Cunningham explains that many companies prefer to use pro forma reporting because it allows the company to ignore many items GAAP considers expenses such as commissions, disbursements to start new subsidiaries, and marketing and personnel costs. Id.

61. Cunningham, supra note 6, at 931.


63. SCHULMAN ET AL., supra note 9, at 299; see also Bloomberg News, Concern to Restate Results, N.Y. Times, Oct. 22, 2002, at C12.

64. § 101, 116 Stat. at 750.

65. § 101(a), 116 Stat. at 750.

66. SCHULMAN ET AL., supra note 9, at 300.


68. Pulliam, supra note 66, at A1; Sandberg & Susan Pulliam, supra note 66, at A3.


70. Cunningham, supra note 6, at 934-35.
payments should be deducted from revenues in determining net income. However, treated as capital expenditures, the line use payments were not deducted in determining net income, thereby bolstering the profit margin.

When expenses are capitalized in this manner, a true picture of a company's financial condition is nearly unattainable. This practice was so egregiously abused in the WorldCom case that the improper capitalizations could have been easily identified by internal controls, or, at a minimum, revealed during the outside audit. One would imagine such defective internal controls would have been caught by the external audit conducted again by the once venerable Arthur Anderson. Unfortunately, Anderson failed to identify the accounting irregularities. WorldCom's abuse of simple, run of the mill, accounting deception worked to shed light upon failures of the company's internal accounting procedures. Concern over failures in internal control procedures are evidenced by the certification provisions of SOX, which require, inter alia, a company's CFO and CEO to certify to the truthfulness of quarterly and annual reports and further, certify to "establishing and maintaining disclosure controls" designed to "ensure that material information relating to the [company] is made known to the [certifying officer]."

In June 2002, WorldCom announced $3.8 billion in inflated profits; an announcement which lead Nasdaq to force a halt on trading of the company's stock. Former WorldCom executives, Scott Sullivan and Buford Yates, Jr., were indicted on charges of securities fraud for allegedly hiding billions in expenses from investors and auditors. WorldCom's accounting irregularities were ultimately found to be approximately $9 billion. In July of 2002, WorldCom filed for Chapter 11 bankruptcy protection, surpassing Enron as the largest filing in United States history.

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71. BLOOMENTHAL, supra note 51, at § 1.
72. Cunningham, supra note 6, at 936.
73. Id.
75. § 302(a), 116 Stat. at 777.
77. Id.
80. Solomon, supra note 66, at Al.
81. Hamblett, supra note 78, at 1.
Adelphia was a leading cable provider where Chairman and CEO John Rigas, who founded Adelphia, sat on the company's nine member Board of Directors with five other Rigas family members, including his three sons.\textsuperscript{82} The Rigas family used Adelphia as their personal money tree, borrowing $2.3 million through various family owned partnerships.\textsuperscript{83} Unfortunately, all such transactions occurred off the balance sheets so that shareholders had no means of knowing about the massive borrowing taking place within the company.

Tyco International is a Bermuda based conglomerate operating in more than 100 countries providing electronics, engineered products and services, healthcare and specialty products, and fire and security services.\textsuperscript{84} Tyco's corporate loan programs were instituted to aid employees in paying taxes on company stock and for relocation near Tyco's Manhattan headquarters.\textsuperscript{85} Through this program, Tyco's CEO and CFO each took in hundreds of millions of dollars which they, acting through the Board of Directors, later forgave.\textsuperscript{86} Both the Tyco and Adelphia scandals are implicated in a section of SOX that prohibit personal loans to officers or directors or their immediate families.\textsuperscript{87}

II. NEW SECURITIES LITIGATION ISSUES EMERGE IN THE POST-SARBANES-OXLEY FORUM

The Act, spurred by the highly publicized corporate scandals, deflated market indexes, and a growing concern amongst the con-
This fast paced promulgation resulted in little formal legislative history regarding the Act because few hearings were held and meaningful debate as to certain provisions was lacking. As a result, issues, then unforeseen by legislators, have emerged. The unanticipated consequences in terms of the Act’s affect on private securities litigation are of primary importance because Congress did not include any measures in SOX, which would modify the PSLRA pleading requirements or in any way directly help plaintiffs bring a private action under securities legislation. As a result, any significant change in the arena of private securities litigation will be born of the interpretation of SOX, as opposed to any directive specifically enumerated therein. The possibility, or more aptly, the high probability, that the plaintiffs’ bar will go through SOX with a fine-toothed comb, with hopes that the legislation will reveal new authority for private securities fraud claims, is surely of great interest to corporate counsel.

Stanford’s Professor Joseph Grundfest, a former SEC Commissioner, who works with the Securities Class Action Clearinghouse, was quoted in reference to Sarbanes-Oxley’s impact on securities litigation as saying “[i]t is more opportunities for plaintiffs lawyers... [t]here’s no doubt about that.” Notwithstanding Mr. Grundfest’s opinion, language expressing a definite intent to modify requirements applicable to private securities litigation is conspicuously absent from the Act, as well as SEC regulations adopted thereunder. However, from a practitioner’s perspective, the new provisions and regulations may affect private causes of action for alleged violations of securities laws. Courts will be forced to address provisions of the Act that could alter private se-

90. Coffee, supra note 87, at 5.
91. HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE § 74 (2002).
curities litigation before one can ultimately decipher the long term impact of the legislation in such matters. Accordingly, the following discussion is an effort to identify certain portions of the Act, which may provide some insight into the issues courts will be faced with in the future when dealing with SOX.

A. **Practical Effects of an Extended Limitation Period for Private Securities Fraud Claims**

The Act incorporates the Corporate and Criminal Fraud Accountability Act of 2002, and as added by an amendment in the Senate, includes a statute of limitations applicable to private actions for securities fraud. The Act alters the statute of limitations applicable to violations of securities laws, which represents the “sole direct change to shareholder litigation.” Before the enactment of SOX, a private cause of action pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, must have been brought no later than the earlier of one year after a party was aware of the injury or was on “inquiry notice” of the violation, or three years from the date of the last violation.

Sarbanes-Oxley modifies the limitations period for private claims involving allegations of fraud, deceit, or manipulation. Under SOX’s new limitations period such claims must be brought no later than the earlier of either two years after discovery of facts constituting the violation or five years from the date of the viola-

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93. Schmitt et al., supra note 91, at A1. “Obviously some lawsuits are going to spring up out of some of the regulatory provisions, but only time will tell if its going to be a trickle or a torrent,” said Patrick McGurn, a vice president at Institutional Shareholder Services, a proxy advisory firm in Maryland.” Id.


98. Controlling case law defined “inquiry notice” as “the term used for knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal rights had been infringed.” Theoharous v. Fong, 256 F.3d 1219, 1228 (11th Cir. 2001).


100. § 804(b), which institutes the extended limitations period, reads as follows:

(b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in Section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(47)), may be brought not later than the earlier of (1) 2 years after discovery of the facts constituting the violation; or (2) 5 years after such violation.

28 U.S.C. § 1658
The Act does not alter the limitations period for claims that do not involve allegations of "fraud, deceit, or manipulation or contrivance in contravention of regulatory requirements" actionable under the Securities Act of 1933, The Securities Exchange Act of 1934, the Investment Advisors Act of 1940, the Trust Indenture Act, or the Public Utility Holding Company Act of 1935.

However, this provision of the Act does work to extend the limitations period for 10b-5 claims. In the Congressional Section by Section Analysis of Sarbanes-Oxley, Senator Leahy described the new limitations period as "[i]ntended to lengthen any Statute of Limitations under federal securities laws, and to shorten none. . . . [t]he section, by its plain terms, applies to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred."

This language indicates that the new limitations period under section 804 of Sarbanes-Oxley may apply retroactively. Indeed, in March of 2003, the district court in Roberts v. DeanWitter held that the Act applied retroactively to lengthen the limitations period for claims that arose before the enactment of Sarbanes-Oxley in July 2002, but were filed after its enactment. In Roberts, at issue were trades made in early 1998, which plaintiff alleged were unsuitable and unauthorized. Pursuant to the limitations period applicable before the enactment of Sarbanes-Oxley, the plaintiff's cause of action would have been outside the three-year limitations period in 2001. However, under the new five-year period in Section 804, plaintiff's cause of action was still viable.

Normally, courts are unwilling to retroactively apply a statute of limitations in absence of a clear expression of Congressional intent. In the Roberts case, the court relied, in part, on statu-

101. Sarbanes-Oxley Act, § 804.
102. BLOOMENTHAL, supra note 90, at § 74 (quoting Sarbanes-Oxley Act, §804(a) (amending 28 U.S.C. § 1658, by adding subsection (b))).
111. Id. at *5.
112. Id. at *8-9, 12.
113. Id. at *8 (citing Resolution Trust Corp. v. Seale, 13 F.3d 850, 853 (5th Cir. 1994)).
tory language in § 804(b) of the Act providing that the lengthened limitations period applies to a "proceeding . . . commenced on or after the enactment of this Act." The court reasoned that had Congress intended the statute to apply prospectively only, the language would have referred to violations occurring after the statute's enactment. Congressional reasoning behind the lengthened limitations period is premised upon the belief that a longer statute of limitations will allow defrauded investors a more meaningful opportunity at redress where the perpetrators have concealed evidence of the fraud.

Micheal A. Perino, Visiting Professor at Columbia University School of Law, examined a detailed sample of one hundred and sixty securities fraud class actions filed from July 1998 to June 2001 to determine the efficiency of the former, more restrictive statute of limitations. On average, the examined claims were brought within fifty-five days of the end of the class period. Nearly ninety percent of the claims were brought within six months of disclosure of the alleged misconduct. Both statistics indicate that the plaintiffs' bar was accustomed to, if not adept at, bringing claims within one year of discovery of the misconduct, which is clearly within the former limitations period. The Enron and WorldCom transgressions are perfect examples. In both cases, there were class actions filed within days of accounting re-statements by the two companies.

Currently, the impact of the extension of the limitations period remains unclear. Section 804, which creates the extended statute of limitations expressly states that nothing contained therein "shall create a new, private right of action." Although the new provision represents a substantial increase in the time allowed for

114. Id. at *8-9.
117. Id.
118. Id.
119. Id.
121. § 804(c), 116 Stat. at 801. "This provision states that it is not meant to create any new private cause of action, but only to govern all the already existing private causes of action under various federal securities laws that have been held to support private causes of action." 148 CONG. REC. S7418 (daily ed. July 26, 2002).
bringing certain private causes of action under securities laws, it may not effect the quantity and feasibility of applicable claims because most are filed immediately upon publication of substantial declines of the corporation's stock price.\textsuperscript{122}

Alternatively, section 804 will affect securities litigation in a practical sense because extending the limitations period will work to lengthen the class period, which in turn affects the calculation of damages and class size.\textsuperscript{123} Issues may arise as to subclasses, choice of lead counsel and lead plaintiff, along with increased difficulty reaching agreements as to settlement arrangements.\textsuperscript{124} Furthermore, a longer limitations period could allow the plaintiffs' bar to gather information that may reveal claims against attorneys, auditors and bankers, rather than just the company itself.\textsuperscript{125}

B. Use of Shareholder Derivative Suits to Enforce SOX Provisions

A more subtle issue, as to the impact of SOX, on securities litigation stems from the forfeiture provision contained in section 304.\textsuperscript{126} Section 304 provides for the forfeiture of bonus, incentive, or equity based compensation or any profits received from stock trades by a CEO or CFO where the issuer was required to restate financial statements because of any wrongful, material noncompliance with a financial reporting requirement under the Act.\textsuperscript{127} This provision fails to identify which party would have the right to enforce the prohibition contained therein. Should the right to disgorgement under section 304 be vested in the corporation itself, which one would assume is the case, there lies a potential for shareholder derivative actions should the corporation fail to demand that executives relinquish the funds.\textsuperscript{128}

\textsuperscript{122} Robert J. Jossent \\& Neil A. Steiner, Using Sarbanes-Oxley in Securities Litigation, N.Y. L.J., April 14, 2003, at S3 (col. 1).
\textsuperscript{123} Id.
\textsuperscript{124} Id.
\textsuperscript{125} Id.
\textsuperscript{126} § 304, 116 Stat. at 777.
\textsuperscript{127} § 304(a), 116 Stat. at 777.
\textsuperscript{128} BLOOMENTHAL, supra note 90, § 74. According to Bloomenthal, "this provision on its face could apply retroactively" to financial restatements "made after enactment of the Act, but pertaining to financial periods prior to adoption of the Act." \textit{Id.} at § 65. That possibility raises an issue for two reasons. First, it is unknown which party can assert a claim under the provision. \textit{Id.} Second, the provision contains no statute of limitations so such issues may arise for an indefinite period of time. \textit{Id.}
In contrast, section 306 makes it unlawful for an officer or director to acquire or trade the issuer’s equity securities if received in connection with that officer’s or director’s service, during a pension fund blackout period. This provision expressly allows actions by the corporation to recover the funds and also authorizes shareholder derivative suits where the corporation fails to demand disgorgement. Therefore, CEO’s and CFO’s who violate section 304 have valid arguments that had Congress intended section 304 to be subject to enforcement through shareholder derivative suits, the Act would have explicitly called for such remedy in a manner similar to the language contained in section 306. Moreover, the Supreme Court’s ruling in Burks v. Lasker, holds that a Board of Directors may terminate a shareholder derivative suit if allowed by state law even where the claim alleges a non-frivolous cause of action for violation of federal law. As a result, valid shareholder derivative suits under either section may be properly terminated by the company’s board.

C. Arguments Abound as to the Existence of an Implied Private Right of Action Under Sarbanes-Oxley

Any discussion of SOX’s projected impact on securities litigation begs the question of whether an implied private right of action exists under any of the various prohibitions contained in the Act. If courts allow an implied private right of action for conduct proscribed by SOX, the result could be a shift away from the ordinary 10b-5 action and towards remedies that would hold defendants accountable for specific conduct prohibited by SOX. Alternatively, should courts refuse to recognize implied private rights of action pursuant to SOX provisions, plaintiffs will be forced to rely primarily on 10b-5 actions when alleging securities fraud, and they will also have to continue to satisfy PSLRA requirements.

With the exception of two provisions discussed below, the Act contains no language permitting or restricting implied private rights of action in terms of the numerous SOX sections, which create criminal violations and make specific conduct or omissions unlawful. The first exception is section 804 of SOX, which

129. § 306(a), 116 Stat. at 779.
132. Burks, 441 U.S. at 485.
133. BLOOMENTHAL, supra note 90, § 74.
lengthens the limitations period for claims involving securities fraud and expressly states that no new, private cause of action is created.\textsuperscript{134} Second, section 303 of SOX contains a provision which makes it unlawful for an officer or director of a public company to fraudulently influence or mislead auditors engaged in auditing the company's financial statements.\textsuperscript{135} This section states on its face that the SEC has \textit{exclusive} authority to enforce the provision.\textsuperscript{136}

Clearly, Congress could have included a clause stating that nothing contained in the Act shall be deemed to create an implied private right of action. Alternatively, it could be countered that an express private cause of action could have easily been provided for if Congress so intended. The Supreme Court, in \textit{Cort v. Ash},\textsuperscript{137} laid out the framework under which determinations of whether an implied private right of action exists shall be made.\textsuperscript{138} Plaintiffs' counsel, who wish to allege an implied private cause of action pursuant to a provision of SOX, will have to show that (1) the plaintiff is "one of the class for whose \textit{especial} benefit the statute was enacted,"\textsuperscript{139} (2) an "indication of legislative intent, explicitly or implicitly, to create such a remedy or to deny one,"\textsuperscript{140} (3) implying such a remedy is consistent with the underlying purposes of the legislative scheme in question,\textsuperscript{141} and (4) the cause of action is not one traditionally relegated to state law, so that inferring a cause of action under federal law would not be inappropriate.\textsuperscript{142}

\textbf{D. Sarbanes-Oxley Certification Provisions May Provide New Forms of Proof for Plaintiff's in Securities Fraud Cases}

The certification provisions of SOX may have the most pervasive impact on securities litigation. This is so because the certification provisions are inescapably intertwined with 10b-5 actions and the PSLRA pleading requirements. Section 302 of the Act requires the SEC to implement rules under which principal executive and financial officers of public companies certify to the general truth-

\begin{itemize}
\item \textsuperscript{134} § 804(c), 116 Stat. at 801 (amending 28 U.S.C. § 1658).
\item \textsuperscript{135} § 303(a), 116 Stat. at 778.
\item \textsuperscript{136} § 303(b), 116 Stat. at 778.
\item \textsuperscript{137} 422 U.S. 66 (1975).
\item \textsuperscript{138} \textit{Cort}, 422 U.S. at 78.
\item \textsuperscript{139} \textit{Id.} at 78 (quoting Texas & Pacific R. Co. v. Rigsby, 214 U.S. 33 (1916)).
\item \textsuperscript{140} \textit{Cort}, 422 U.S. at 78.
\item \textsuperscript{141} \textit{Id.}
\item \textsuperscript{142} \textit{Id.}
fulness of the company's quarterly and annual reports. The certification would require officers to state that based on his or her knowledge, the report does not contain any material misrepresentations or omit any material fact otherwise necessary to make the other disclosures not misleading. Additionally, the report has to identify the officer's basis for making the certification and each officer must certify that he or she and other officers are "responsible for establishing and maintaining" disclosure controls and procedures. Consequently, disclosure controls must be designed "to ensure that material information relating to the issuer... is made known to [the certifying officer]." The certifying officers must also certify to having "evaluated the effectiveness of the issuer's internal controls" and procedures within the previous ninety days and have "presented in the report their conclusions about the effectiveness" of the disclosure controls and procedures. Moreover, certifying officers must sign off on having disclosed to audit committees and auditors any significant deficiencies in internal control procedures as well as any fraud, whether material or not.

Neither section 302 nor its implementing regulations make any reference to the creation of a private cause of action or indicate an intent to modify securities fraud pleading requirements under the PSLRA. It is clear that the new certification requirements will increase the probability that a company will have to restate earnings, an act which often directly precedes shareholder litigation.

The usual route for officers and directors facing 10b-5 liability is to plead lack of knowledge or specific intent by relying on failures in the PSLRA's proof of scienter requirement to avoid liability for

143. § 302(a), 116 Stat. at 777. The periodic reports subject to §302 and SEC rules promulgated thereunder are located in §§ 13(a) and 15(d) of the Securities Exchange Act of 1934. 15 U.S.C. 78m, 78o(d); 17 C.F.R. § 240.13a-14(b)(2).


146. Id. The certification provisions implicitly require the establishment of internal control systems sufficient to make information available to certifying officers. H. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE, § 33 (2002).

147. § 302(a)(4)(C)(D), 116 Stat. at 777

148. Sarbanes-Oxley Act, § 302(a)(5)(A), (B), 116 Stat. at 777. Further, Sections 906(a) and 906(b) require that each periodic report filed by the issuer with the SEC is accompanied by a statement by the CEO or CFO certifying that the report fairly represents the financial condition of the issuer on all material respects. Sarbanes-Oxley Act, § 906(a), 116 Stat. at 806 (amending 18 U.S.C. by adding § 1350).

149. BLOOMENTHAL, supra note 90, at § 74.

having signed off on deficient reports. In an effort to counter such arguments, the SEC implemented rules pursuant to the certification provision of section 302, which specifically mandated that false certifications would expose the CEO and/or CFO to private causes of action under 10b-5.

Even prior to the adoption of Sarbanes-Oxley and its new certification requirements, CEOs and CFOs were often named as defendants in private securities fraud litigation and the SEC was taking action pursuant to its authority against the individual officers. A longstanding requirement under 10b-5 compels plaintiffs to plead scienter or the intent to commit fraud. The PSLRA increases the difficulty of commencing securities fraud actions by strengthening the scienter requirement so that pleadings alleging a 10b-5 violation must contain specific allegations of fact giving rise to a "strong inference" that the named defendants acted with the requisite scienter. Until a plaintiff can establish such a "strong inference" of scienter, he or she is vulnerable to a motion to dismiss and at minimum, is unable to proceed to discovery, where there lies the greatest potential to obtain proof of scienter.

Certification requirements may enable an easier passage for private litigants to meet the enhanced pleading requirements of the PSLRA in that the Act, literally unchanged by SOX, mandates pleadings which create a strong inference that the defendant acted with the requisite state of mind. The scienter standard for securities fraud claims requires a showing of the defendant's knowledge or, at bare minimum, reckless disregard of the alleged misrepresentations. As a result, a cause of action for securities fraud cannot withstand containing allegations of merely negligent, or even grossly negligent, misrepresentations on the part of the defendants.

Prior to the enactment of Sarbanes-Oxley, courts contemplating the PSLRA's pleading standards found boilerplate allegations in reference to a given defendant's knowledge of misrepresentations

151. Id.
152. Id.
153. Sorin et al., supra note 2, at 978.
154. Id.
155. Id. However, it should be noted that exact requirements for alleging scienter vary by circuit. Id. See, e.g., Kalnit v. Eichler, 264 F.3d 131, 138-39 (2d Cir. 2001) (typifies a more flexible interpretation of the PSLRA scienter requirement); In re Silicon Graphics, Inc., 183 F.3d 970, 974 (9th Cir. 1999) (example of a more stringent interpretation).
156. Sorin et al., supra note 2, at 978.
157. Id.
or omissions unconvincing.\textsuperscript{158} However, SOX certification provisions requiring the establishment and maintenance of internal control systems may persuade courts that a strong inference the defendant acted with the requisite scienter exists and once past the PSLRA pleading requirements, discovery will reveal the existence of internal reports effectively resolving the issue of an individual defendant's knowledge or lack thereof.\textsuperscript{159}

There are two primary ways in which the SOX certification provisions could be used to further the securities fraud suits of private plaintiffs. First, the certifications could be used as evidence from which defendant's knowledge of the misrepresentations or reckless disregard of them could be inferred. Second, the certification itself could be used as direct evidence of defendant's knowledge or reckless disregard.

Pursuant to the first theory, plaintiffs would use certification requirements as circumstantial evidence of the particular defendant's knowledge of the misrepresentations or reckless disregard of their truth or falsity. In essence, this argument would use a certification containing a misrepresentation as to the company's financial condition against the certifying officer or director to infer that that officer or director had knowledge of the misrepresentation. Potential plaintiffs could further extend this theory by alleging facts which would buttress an inference that corporate officers certified to their disclosure procedures in reckless disregard of the company's subpar internal controls or lack thereof.\textsuperscript{160} Such an extension would allow potential plaintiffs to argue that the named defendants had knowledge of all misrepresentations as to the company's financial condition occurring within the reporting period subject to those allegedly deficient internal controls.

Pursuant to the second theory, plaintiffs would allege that the certification itself is direct evidence of the particular defendant's knowledge of the misrepresentation or reckless disregard of them.\textsuperscript{161} Consequently, the certification would provide the "particular facts" that the PSLRA requires of plaintiffs' pleadings so

\begin{footnotesize}
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\item[158.] BLOOMENTHAL, supra note 90, at § 74.
\item[159.] BLOOMENTHAL, supra note 90, at § 74. According to Bloomenthal, certification requirements "will make it much more difficult for the certifying officer as defendants in a private action to claim they did not know and should aid plaintiffs in meeting pleading requirements of PSLRA." \textit{Id}.
\item[160.] \textit{Id.} Reckless disregard constitutes the lowest actionable scienter standard under the PSLRA. \textit{Id}.
\item[161.] \textit{Id.}
\end{itemize}
\end{footnotesize}
that, in theory, plaintiffs could overcome a motion to dismiss and thereby, proceed to discovery.

E. Sarbanes-Oxley Muddies the Water for Determinations of Whether One is a "Primary Violator" in Securities Fraud Cases

According to the United States Supreme Court's ruling in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, there is no liability under 10b5 for the aiding and abetting of securities fraud. In effect, this means that liability for violations of securities laws extends only to primary actors. The ruling in Central Bank worked to shield many accountants, lawyers, and banking institutions from liability for actions in furtherance of fraud perpetrated by primary violators. The jurisprudence after the decision in Central Bank holds persons liable only if he or she actually made the false or misleading statements or specifically acquiesced or adopted others' false or misleading statements.

SOX may also alter the liability of attorneys who in some manner facilitate a violation of securities laws, although no private cause of action is specifically created. The liability of attorneys may be modified by SOX because proving that a particular lawyer was a primary actor in reference to 10b-5 violations may now be a less difficult task. Rules implemented by the SEC pursuant to authority granted in SOX may affect the liability of an attorney who supplies legal services to an issuer in connection with the preparation of documents filed with or submitted to the SEC.

The liability of attorneys is affected because pursuant to those Rules, the attorney could be viewed as a primary actor in securities fraud based on the rationale that an attorney "speaks" by allowing his or her work to be employed in the filing of documents filed with or submitted to the SEC.

162. Central Bank, 511 U.S. at 191. It should be noted that § 703 of the Act requires the SEC to study aiding and abetting violations that go unsanctioned. § 703, 116 Stat. at 798. This seems to be an anomaly as conduct deemed "aiding and abetting" another's securities fraud is carries no civil liability so that it should never be sanctioned in the first place. Perhaps, this study can be read as questioning the continuing validity of the Supreme Court's holding in Central Bank.

163. Central Bank, 511 U.S. at 177.


165. Jossent & Steiner, supra note 120, at S3.

166. Id.

167. Id.
with the SEC that contain false or materially misleading statements or omissions. As the analysis continues, potential plaintiffs could argue that the attorney adopted or acquiesced to those statements, thus establishing himself or herself as a primary violator in accordance with the standard set forth in Central Bank. Prior to the enactment of Sarbanes-Oxley and pursuant to the ruling in Central Bank, such conduct would have been viewed only as "aiding and abetting" another's perpetration of securities fraud, for which the attorney would not be liable. It is unknown whether Sarbanes-Oxley could be used to subject attorneys to 10b-5 liability. However, such attorney liability may be unlikely as the above analysis is held together by somewhat tenuous bonds which may be easily attacked by defendants and can change according to the facts of each case.

III. CONCLUSION

Absent Congressional amendments, SOX's ambiguities will have to be resolved through litigation. The process of having lawyers promote, and courts ultimately decide, the resolution of ambiguous legislation is further frustrated where, as is the case with SOX, formal legislative history is lacking. Normally, a court faced with unclear legislation will turn first to formal legislative history for clarity; however, there is very little history for a court to examine when faced with a Sarbanes-Oxley ambiguity. Moreover, the enormity of the corporate scandals created an atmosphere in which members of Congress wanted to avoid the appearance of condoning such behavior. As a result, meaningful debate, especially as voiced by opponents, and the usual resulting compromises over legislative measures, are nearly absent from the Act's history.

It appears that SOX's ambiguities are rooted in Congress' attempt to assuage the concerns of a public facing a barrage of corporate transgressions in an already weakened economy. Clearly, it was not a concerted effort to change the application of securities laws to private plaintiffs because requirements of the PSLRA and the Supreme Court's holding in Central Bank are untouched and remain valid. However, as the discussion regarding certification provisions indicated, SOX may provide supplementary avenues

168. Id.
169. Id.
through which the requirements of the PSLRA and ruling in Central Bank may be satisfied. Thus, the direction of securities litigation in a post Sarbanes-Oxley forum will be battled out and finally resolved in court. What is unknown is whether such litigation will arrive at courts as the sporadic case representing a distinct issue, or as a 'floodgate' of litigation, the resolution of which will produce a long-term impact in the area of private securities litigation.

Kourtney T. Cowart