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Unfit to Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies After the Sarbanes-Oxley Act

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NOTES

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I. INTRODUCTION

On June 4, 2003, lifestyle guru Martha Stewart was indicted on multiple criminal and civil charges by the Securities and Exchange Commission (SEC or Commission).[1] The charges, including obstruction of justice and civil insider trading, stemmed from Stewart's sale of ImClone stock shortly before the Food and Drug Administration rejected a drug produced by ImClone and sent the company's stock price tumbling.[2] Although Stewart could face a number of serious penalties under her criminal indictment, the primary remedy sought by the SEC for her civil insider trading charges is rather uncommon—a bar from serving as a director of Martha Stewart Living or any other public company.[3]

The SEC's attempt to bar Martha Stewart from serving as a director came on the heels of new "officer and director bar" legislation that was passed in the wake of the collapse of Enron and other recent corporate scandals.[4] In response to public outcry over these corporate

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1. Troy Wolverton, *It May Be No-Win for Martha Stewart Living*, TheStreet.com (June 4, 2003), *at* http://www.thestreet.com/stocks/troywolverton/10091570.html.

2. *Id.*

3. *Id.*

4. The first large-scale scandal that rocked securities markets involved the Enron corporation, which slid into bankruptcy after it slowly became clear that accounting tricks had been hiding massive losses on the corporate books for years. Marianne Lavelle, *The Actions of Corporate Honchos Horrified the Nation. So When's the Day of Reckoning?*, U.S. NEWS AND WORLD REP., Dec. 30, 2002, at 34. Shortly thereafter, Adelphia Communications's CEO was taken away in handcuffs after the revelation of billions of dollars of off-balance sheet loans made to his family and guaranteed by the company. *Id.* at 40; *see also* Greg Levine, *Faces in the News*, Forbes.com (July 24, 2002), *at* http://www.forbes.com/2002/07/24/0724facesam_print.html. Then, WorldCom announced that it had improperly accounted for expenses in previous years, and it,

scandals, Congress enacted the Sarbanes-Oxley Act, which President Bush signed into law on July 30, 2002.[5] The Sarbanes-Oxley Act added a number of provisions to the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) in an attempt to increase the accuracy of audits and financial disclosures and to increase the accountability of and penalties for dishonest corporate officers and directors.[6] In comments at the signing, President Bush discussed the need to restore public faith in America's economic system and noted ways that the new bill would increase corporate oversight and stiffen penalties for corporate wrongdoers.[7] Sarbanes-Oxley increased authority to the SEC by allowing the SEC to permanently bar corporate wrongdoers from serving as officers or directors of any publicly traded company.[8] Upon signing the act into law, President Bush declared that "[t]he SEC will now have the administrative authority to bar dishonest directors and officers from ever again serving in positions of corporate responsibility."[9]

Two specific sections of the Sarbanes-Oxley Act changed the existing law concerning suspension of officers and directors. The first is section 305, "Officer and Director Bars and Penalties," which modifies the 1933 and 1934 Acts by lowering the standard that the SEC has to meet to persuade a federal court to issue an officer or director bar.[10] The second, more important change is found in section 1105, "Authority of the Commission to Prohibit Persons from Serving as Officers or Directors."[11] This section allows the SEC, for the first time, to issue officer and director bars *directly* as part of a cease-and-desist proceeding, thereby eliminating the requirement that the SEC go through a federal court.[12] Under these provisions, if an officer or

too, entered bankruptcy after $9 billion in misstated earnings were revealed. Lavelle, *supra*, at 36. The scandals continued with Tyco's Dennis Kozlowski siphoning $600 million in company money for his personal use and with the discovery of accounting fraud at Global Crossing—the list is all too long. *See id.* at 33, 36.

5. *See* Phyllis Plitch, *Execs Seen 'Scrambling' to Meet New Certification Rules*, DOW JONES NEWS SERVICE, Sept. 3, 2002, WL 9/3/02 DJNSPLUS 17:30:00.

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-66).

7. President George W. Bush, Remarks to Attendees at Signing of Corporate Corruption Bill (July 30, 2002), http://www.whitehouse.gov/news/releases/2002/07/20020730.html [hereinafter President Bush's Remarks].

8. Sarbanes-Oxley Act §§ 305, 1105.

9. Bush, *supra* note 7. This change had been recommended in President Bush's ten point plan. 148 CONG. REC. H1553 (daily ed. Apr. 24, 2002) (statement of Rep. LaFalce). Point five of President Bush's proposal was that "CEOs . . . should lose their right to serve in any corporate leadership positions." *Id.*

10. Sarbanes-Oxley Act § 305.

11. Sarbanes-Oxley Act § 1105.

12. *Id.*

director's conduct both violates an antifraud provision of federal securities laws[13] and demonstrates "unfitness" to serve, the SEC may bar that officer or director from serving in that capacity with any other public company in the future.[14] The SEC can pursue such a bar in an administrative cease-and-desist proceeding or an action brought in the courts.[15]

By enacting sections 305 and 1105 of the Sarbanes-Oxley Act, Congress has made it easier for the SEC to permanently bar securities law violators from corporate boardrooms. Prior to Sarbanes-Oxley, relatively few such permanent suspensions were obtained.[16] Under Sarbanes-Oxley, the SEC no longer has to show a defendant's "substantial unfitness" to serve as an officer or director but, instead, only has to show his or her "unfitness."[17] This deletion of one word may appear insignificant, but it is the result of substantial congressional debate, and it should signal to courts that Congress is not satisfied with the high standard judges have required the SEC to meet in the past.[18] Moreover, the permanent suspension may become increasingly important in the future as political pressure in the wake of the Enron debacle and other scandals forces the SEC to crack down on corporate fraud more vigilantly.[19]

This Note analyzes the wisdom and necessity of Congress increasing the SEC's permanent suspension powers. Part II provides background on the SEC's suspension powers before Sarbanes-Oxley was enacted, focusing particularly on the Remedies Act of 1990. Part III examines the changes to the SEC's suspension powers wrought by the Sarbanes-Oxley Act, some of the iterations that existed in the Act's legislative history, and the likelihood that these provisions will be used more frequently in the future. Parts IV and V address whether the SEC's increased suspension powers are necessary. This Note argues that, while forces such as market pressures, national exchange rules, and criminal and civil sanctions provide strong investor protection, there are situations in which those forces are not

13. The antifraud provisions are section 17(a)(1) of the 1933 Act, the SEC rules promulgated thereunder, and section 10(b) of the 1934 Act and the rules promulgated thereunder. *Id.*

14. *Id.*; Sarbanes-Oxley Act § 305.

15. Sarbanes-Oxley Act § 1105; *see also* Mark S. Bergman, *Congress Passes Accounting Reform and Corporate Governance Legislation*, ANDREWS SEC. LITIG. & REG. REP., Aug. 28, 2002, at 16.

16. *See infra* Part II.

17. Sarbanes-Oxley Act § 305.

18. *See infra* Part III.B (discussing Rep. LaFalce's critique of the previous judicial standard).

19. *See infra* Part III.E.

sufficient. It is in these situations that SEC suspensions are necessary to prevent fraud and serious harm to investors. Part VI addresses certain concerns that have been raised about due process and the potential impact of the SEC's expanded power on the availability of qualified directors, arguing that the benefits of the SEC's permanent suspension powers outweigh the risks in these areas. This Note concludes that, on balance, the SEC's increased suspension powers will benefit United States markets. It then offers a few suggestions concerning enforcement in the coming years.

II. SEC REMOVAL ACTIONS PRIOR TO SARBANES-OXLEY

A. SEC Injunctions and Removal Actions Prior to the Remedies Act of 1990

Before the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act) was enacted, the SEC did not have specific statutory authority to permanently bar people from serving as officers or directors.[20] Under 15 U.S.C. § 78u(d)(1), the SEC was able to seek (from the federal courts) temporary and permanent injunctions forbidding defendants from violating securities laws in the future, but the SEC had no specific authority to permanently suspend defendants from acting as directors.[21] For example, in *SEC v. Benson*, the SEC brought an action against a company president who engaged in a fraudulent scheme to divert over $500,000 from the manufacturing company at which he worked in violation of numerous provisions of the federal securities laws.[22] The district court "permanently enjoined [the president] from future violations of the Federal securities laws."[23] This sort of injunction had no immediate direct effect, as the defendant was not free to violate securities laws before the injunction. However, the injunction could damage a defendant's reputation and lead to more severe penalties if further violations occurred.[24]

20. 15 U.S.C. § 78u (2000). Note that subsections (d)(2) and (d)(3) were added as part of the Remedies Act on October 15, 1990.

21. § 78u(d)(1).

22. 657 F.Supp. 1122, 1124 (S.D.N.Y. 1987).

23. *Id.* at 1134.

24. *See* SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1102 (2d Cir. 1972) (holding that in spite of the harmful impact that injunctive relief would have on the reputations of certain individual defendants, a permanent injunction was properly issued against them in light of the blatant nature of their violations and their professional occupations which put them in positions where they could misappropriate investor funds in later offerings).

The primary purpose of these SEC injunctions was to prevent further violations rather than to punish violators.[25] In fact, a remedy found to be primarily punitive could be overturned. SEC injunctions were therefore only to be issued where there was a risk of future violations.[26] To determine whether a future violation was likely, courts looked to the totality of the circumstances and considered five specific factors including the defendant's degree of scienter and remorse concerning the original violation, the defendant's previous record of wrongdoing, and whether the defendant's occupation put him in a position to commit further violations.[27] The burden of proof regarding the likelihood of future violations rested with the SEC.[28]

Although it lacked the statutory authority to seek a permanent bar prior to the Remedies Act, the SEC managed to get some defendants to submit to temporary or permanent suspension through consent decrees. As of 1989, the SEC had never secured a *court order* suspending an executive, but it had secured *consent decrees* for temporary or permanent suspension of approximately one hundred individuals.[29] Several of these consent decrees prohibited defendants from ever again serving as officers or directors of any public company.[30] In other cases, defendants agreed to lesser suspensions,

25. SEC v. Koracorp Indus., Inc., 575 F.2d 692, 697 (9th Cir. 1978).

26. SEC v. Parklane Hosiery Co., 558 F.2d 1083, 1089 (2d Cir. 1977) (holding that the SEC cannot obtain injunctive relief under the Securities Exchange Act where there is no reasonahle likelihood of a repeated violation of the Act).

27. SEC v. Bonastia, 614 F.2d 908, 912 (3d Cir. 1980) (holding that the crucial test in deciding whether a permanent injunction should be issued is whether there was a reasonable likelihood that the wrong would be repeated). The likelihood that the wrong will be repeated should take into account the totality of circumstances, and should include consideration of the following: (1) existence of past violations; (2) degree of scienter involved; (3) whether the infraction was an isolated occurrence; (4) whether defendant continues to maintain that past conduct was blameless; (5) whether, because of profession or occupation, the defendant might be in a position where future violations can be anticipated. *Id.*

28. SEC v. J & B Indus., Inc., 388 F. Supp. 1082 (D. Mass. 1974) (stating that the SEC must meet "proper showing" standard of statutes and must present a prima facie case of securities laws with reasonable likelihood that the violation will be repeated).

29. *See* Stephen M. Cutler, Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002), http://www.sec.gov/news/speech /spch538.htm; *see also* Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 NOTRE DAME L. REV. 32, 40 (1989) ("[A] court could fashion a decree in an SEC action seeking injunctive relief which would incorporate an order removing and suspending a miscreant executive from continuing service with the corporation in which misconduct occurred; however, none has ever done so in a fully litigated proceeding. Rather, the SEC has secured such orders solely in the context of negotiated consent decrees.").

30. *See, e.g.*, SEC v. Gulf Res., Inc., No. CA-3-83-1653H, 1984 SEC LEXIS 2168, at *1-2 (N.D. Tex. Feb. 21, 1984) (defendant prohibited from becoming or acting as an officer, director or control person of any public company absent SEC permission); SEC v. Weil, No. 79-440-Civ-T-H, 1979 SEC LEXIS 1803, at *1-2 (M.D. Fla. Apr. 10, 1979) (complaint requesting that defendant be barred from assuming a position as an officer or director of any publicly traded issuer).

usually ranging from three to five years.[31] The SEC managed to obtain these consent decrees even though it did not have statutory authority to seek court-ordered suspensions until the passage of the Remedies Act in 1990.[32]

B. The Remedies Act of 1990

Wanting to more effectively prosecute corporate criminals, the SEC sought statutory authority to issue permanent bars without involving the courts.[33] In a 1987 report, the National Commission on Fraudulent Financial Reporting (the Treadway Commission), chaired by former SEC Commissioner James C. Treadway, Jr., recommended that "the SEC . . . seek [congressional] authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company."[34] It initially appeared that the SEC would gain this right when the first version of the Remedies Act was introduced in 1989.[35] However, after opposition by groups such as the American Bar Association's Section on Business Law, Richard Breeden, the SEC's new chairman, amended the bill to narrow the SEC's suspension powers.[36] As amended, the bill required that the SEC seek officer and director suspension orders from federal courts rather than being able to issue such orders on its own.[37] Furthermore, the amendments only allowed permanent officer and director bars for securities violations involving "scienter-based fraud."[38]

The amendments recommended by Chairman Breeden were adopted, and, on October 15, 1990, President George H. Bush signed

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31. Barnard, *supra* note 29, at 41 n.70, 54 n.158 (1989) (listing twenty-seven different consent decrees in which defendants agreed to suspensions of various lengths and severities).

32. The SEC sought this authority for some time. As early as 1984, then-SEC Commissioner James Treadway recommended that the SEC should have power to bar executives for securities violations. *SEC Should Have Power to Bar Executives for Securities Violations, Treadway Says*, 16 ANDREWS SEC. REG. & L. REP. at 1487 (1984).

33. REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 66-67 (1987), http://bear.cba.ufl.edu/hackenbrack/acg5637/PDF/NCFFR.pdf.

34. *Id.* at 66.

35. Jayne W. Barnard, *When is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1493 (1992).

36. *Id.* at 1493-94.

37. *Id.*; *see also* Matthew Scott Morris, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping Up with the Joneses, the SEC's Enforcement Arsenal Is Modernized*, 7 ADMIN. L.J. AM. U. 151, 158 n.26 (1993).

38. Barnard, *supra* note 35, at 1494. In other words, officer and director bar orders would only be available when there was a violation of section 17(a)(1) of the 1933 Act or section 10(b) of the 1934 Act.

the Remedies Act into law.[39] As enacted, the Remedies Act authorized the SEC to seek temporary or permanent suspensions in federal court against individuals who violated the antifraud provisions of securities laws and who demonstrated substantial unfitness to serve as officers or directors.[40] In several cases decided after the enactment of the Remedies Act, courts claimed that the Remedies Act's suspension provisions were simply a codification of courts' existing authority to fashion an equitable remedy.[41] However, there do not appear to be any pre-1990 cases involving the SEC where courts actually issued such bars.[42]

The Remedies Act also gave the SEC power to issue "cease-and-desist orders" against securities law violators.[43] With this new authority, the SEC could order a person who it believed had violated or was about to violate federal securities laws to cease the illegal activity, make an accounting, and disgorge any unlawful profit.[44] Unlike injunctions, cease-and-desist orders could be issued by the SEC directly, without the need for a court order.[45]

The Remedies Act was a victory of sorts for those in the SEC who sought a more pointed method of dealing with perpetrators of securities fraud and a more effective means of preventing future violations. However, the statute was far from clear as to what sort of behavior would result in a suspension. The statute called for bar orders against individuals who (1) committed securities fraud and (2) demonstrated "substantial unfitness" to serve as officers and directors.[46] The requirements for finding violation of securities fraud

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39. Morris, *supra* note 37, at 159.

40. The new bar provision was added as 15 U.S.C. § 78u(d)(2)-(3), § 77t(e) (2000).

41. SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587, 614 (S.D.N.Y. 1993) ("Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy." (citing SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103 (2d Cir. 1972))); SEC v. First Pac. Bancorp, 142 F.3d 1186, 1193 n.8 (9th Cir. 1998) ("The Act merely codified the equitable authority to impose officer and director bar [sic] which the courts already possessed and exercised." (quoting *Drexel*, 837 F. Supp. at 613)).

42. *See* Barnard, *supra* note 29, at 40.

43. *See* Securities Exchange Act, Pub. L. No. 101-421, § 8A, 104 Stat. 933, 933-34 (1990) (codified at 15 U.S.C. § 77h-1); Securities Exchange Act, Pub. L. No. 101-429, § 21C, 104 Stat. 931, 939 (1990) (codified at 15 U.S.C. §§ 78u-3, 78w(d)).

44. 15 U.S.C. §§ 77h-1, 78u-3(c) (2000).

45. *See* Daniel J. Morrissey, *SEC Injunctions*, 68 TENN. L. REV. 427, 463-64 (2001). Officer and director suspension orders had to be obtained through court-ordered injunctions under the Remedies Act, but after Sarbanes-Oxley, the SEC can issue such orders directly through a cease-and-desist proceeding. *See infra* Part III.

46. 15 U.S.C. §§ 77t(e), 78u(d)(2) (2000).

under section 10(b) and Rule 10b-5 had been spelled out by case law,[47] but the meaning of the additional "substantial unfitness" requirement was unclear. The statute did not define "substantial unfitness," nor did the legislative history of the Remedies Act reveal Congress's intent in adding that phrase.[48] It was therefore left to the courts to decide when a person should be deemed "substantially unfit" to serve as an officer or director of a publicly traded company.

C. Case Law after the Remedies Act

The specific application of the Remedies Act's suspension provisions began to take shape in the mid-1990s. Through a series of cases, courts set parameters for permanent suspension orders and eventually fashioned a judicial definition of "substantial unfitness." According to some in Congress and the SEC, the courts established a definition and set parameters far too stringent, making it excessively difficult for the SEC to permanently suspend corporate wrongdoers.[49]

One of the first suspension cases was *SEC v. Drexel Burnham Lambert, Inc.*[50] In *Drexel*, the SEC sought a permanent and unqualified bar against Victor Posner and his son Stephen, both long-time business associates of financiers Michael Milken and Ivan Boesky.[51] The case was the SEC's third lawsuit against Victor Posner, who previously had been indicted for tax fraud.[52] The Posners were found to have collaborated with Milken and Boesky to violate sections 10(b) and 13(d) of the Securities Exchange Act in order to carry out a hostile acquisition.[53] As a result of their securities fraud, the Posners were able to acquire control of Fischbach Corporation and pay themselves over three million dollars in salary over four years even as the company did poorly.[54] The court noted that this was not the first time Victor Posner had committed corporate waste—in a previous

47. The elements for a cause of action for securities fraud include misrepresentation or omission of a material fact, scienter, reliance, and causation. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

48. *See* SEC v. Shah, No. 92 Civ. 1952, 1993 U.S. Dist. LEXIS 10347, at *19-20 (S.D.N.Y. July 26, 1993) ("The statutes do not define 'substantial unfitness,' and the legislative history is not instructive as to what Congress intended this term to mean." (citing S. REP. NO. 101-337, at 3-4 (1990); H.R. REP. NO. 101-616, at 28-29 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1395-96)).

49. *See infra* notes 89-92, 109 and accompanying text.

50. 837 F. Supp. 587 (S.D.N.Y. 1993).

51. *Id.* at 596.

52. *Id.*

53. *Id.* at 609.

54. *Id.* at 612.

case, he had accumulated $173,270 in restaurant bills at company expense in a single year.[55]

In deciding whether to issue a permanent bar against the Posners, the *Drexel* court did not discuss the meaning of "substantial unfitness," but instead looked to a Senate Banking Committee report on the Remedies Act.[56] The report indicated that permanent bars would be especially appropriate where (1) the violation was egregious, (2) the violator was a recidivist, (3) the violation had occurred by a defendant serving in a corporate or fiduciary capacity, (4) public shareholders lacked control to remove the violator, and (5) broader public concerns were involved.[57] The *Drexel* court found that each of those circumstances applied, and issued a permanent bar against Victor and Stephen Posner.[58] The *Drexel* court stated that "one would be hard-pressed to find more worthy candidates to be barred from serving as officers and directors than the Posners."[59]

The decision in *Drexel* was affirmed by the United States Court of Appeals for the Second Circuit (Second Circuit) in *SEC v. Posner*.[60] In order to avoid ruling on whether the Remedies Act applied retroactively, the *Posner* court upheld the district court's permanent bar based on the court's pre-1990 "general equitable powers" to fashion an equitable remedy.[61] Because the Second Circuit in *Posner* did not affirm based on the Remedies Act, it did not discuss the legislative history as had the lower court.[62] However, it did cite similar aggravating factors such as the defendants' high degree of scienter, their past securities law violations, their lack of assurances against future violations, and the need to protect public investors.[63]

In 1995, a California district court considered another SEC request to bar an executive from serving as an officer or director.[64] In *SEC v. Sands*, a bank executive allegedly violated securities fraud laws by, among other things, improperly booking (as assets) on bank financial statements certain CDs issued by the National Bank of

55. *Id.* at 604.

56. *Id.* at 613 (citing S. REP. NO. 101-337, at 22 (1990)).

57. *Id.*

58. *Id.* at 614-15.

59. *Id.*

60. 16 F.3d 520 (2d Cir. 1994).

61. *Id.* at 521.

62. *Id.* at 521-22.

63. *Id.* The *Posner* court stated, "The [defendants] seem to be shocked by what they see as the draconian remedy of eternal boardroom banishment. We intend our affirmance of [the district court's] judgment in this respect as a sharp warning to those who violate the securities laws that they face precisely such banishment." *Id.* at 522.

64. *See* SEC v. Sands, 902 F. Supp. 1149 (C.D. Cal. 1995).

Liberia that were unfunded and uncollectible.[65] The *Sands* court declined to issue summary judgment concerning the bar but stated that the SEC would bear the burden at trial of proving the likelihood of future securities law violations.[66] Like the *Drexel* and *Posner* courts, the *Sands* court did not engage in any discussion of what constituted "substantial unfitness." Instead, the *Sands* court focused almost exclusively on the likelihood of future violations, looking to precedent for a five-part totality of the circumstances test for predicting them.[67] After a bench trial, the district court ruled in favor of the SEC on all of its claims and permanently barred Mr. Sands from acting as an officer or director of a public company.[68]

The same week that *Sands* was decided, the Second Circuit established a six-part test for "substantial unfitness," one that became the widely adopted standard.[69] In 1993 and 1994, the SEC brought separate actions for insider trading against Ratilal Patel and Dilap Shah, seeking, among other remedies, an order to bar the two from ever serving as officers or directors of a public company.[70] Patel was a founder, director, and senior vice president of a generic drug manufacturing company and Shah was president of a subsidiary of the company.[71] From 1986 through 1988, Shah and Patel paid unlawful gratuities totaling $9,600 to two chemists who worked in the FDA's Generic Drug Division reviewing applications for drug product approvals.[72] During that same period, the company submitted a misleading application to the FDA for approval of a new generic drug.[73] The application contained a backdated certificate intended to conceal the fact that certain required studies had not been performed

65. *Id.* at 1154.

66. *Id.* at 1158.

67. *Id.* ("In predicting the likelihood of future violations, the court looks to the totality of the circumstances surrounding the defendant and his violations. Factors to be considered include (1) the degree of scienter involved; (2) the isolated or recurrent nature of the infraction; (3) the defendant's recognition of the wrongful nature of his conduct; (4) the likelihood, because of defendant's professional occupation, that future violations might occur; and (5) the sincerity of the defendant's assurances against future violations." (citing SEC v. Murphy, 626 F.2d 633, 655 (9th Cir. 1980))).

68. *See* SEC v. First Pac. Bancorp, 142 F.3d 1186, 1188-89 (9th Cir. 1998). This district court decision was affirmed by the Ninth Circuit Court of Appeals, which followed the six-part test used by the Second Circuit in *SEC v. Patel*, 61 F.3d 137, 141 (2d Cir. 1995). *See First Pac. Bancorp*, 142 F.3d at 1193.

69. SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995).

70. SEC v. Patel, No. 93 Civ. 4603, 1994 U.S. Dist. LEXIS 9479, at *5 (S.D.N.Y. July 12, 1994) ; SEC v. Shah, No. 92 Civ. 1952, 1993 U.S. Dist. LEXIS 10347, at *8 (S.D.N.Y. July 26, 1993).

71. *Patel*, 1994 U.S. Dist. LEXIS 9479, at *2; *Shah*, 1993 U.S. Dist. LEXIS 10347, at *2..

72. *Shah*, 1993 U.S. Dist. LEXIS 10347, at *2.

73. *Patel*, 1994 U.S. Dist. LEXIS 9479, at *3.

on the final version of the drug.[74] In the months before news of the bribery became public and led to a large drop in the company's stock price, Patel and Shah both sold a number of shares and avoided losses of $453,203 and $121,340 respectively.[75] In deciding whether to issue a permanent bar, the district court observed that the Remedies Act does not define "substantial unfitness," the legislative history is not instructive as to what the term should mean, and, as of that date, no court had construed the term's meaning.[76]

To determine whether the "substantial unfitness" standard was met for Shah and Patel, the district court adopted a multi-part test recommended in an article by Professor Jayne Barnard.[77] Professor Barnard's article suggested that courts consider six factors when determining substantial unfitness: "(1) the 'egregiousness' of the underlying securities law violation; (2) the defendant's 'repeat offender' status; (3) the defendant's 'role' or position when he engaged in the fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood that misconduct will recur."[78] This six-factor test is similar but not identical to the five-part test used by some courts prior to the Remedies Act to determine the likelihood of future violations.[79] Applying the six-factor test, the district court found that some of the factors were present with respect to each defendant and, on balance, that Patel should and Shah should not be permanently barred from serving as a director or officer of a public company.[80]

On appeal by Patel, the Second Circuit reversed Patel's lifetime suspension.[81] In this decision (*Patel II*), the court validated the district court's use of Professor Barnard's six-part test, but disagreed with the district court's assessment of Patel's behavior and added additional requirements to make the test more stringent.[82] The *Patel*

74. *Id.*

75. *Patel*, 1994 U.S. Dist. LEXIS 9479, at *13; *Shah*, 1993 U.S. Dist. LEXIS 10347, at *20.

76. *Shah*, 1993 U.S. Dist. LEXIS 10347, at *19-20.

77. *Id.* at *20 (citing Barnard, *supra* note 35, at 1510-22).

78. Barnard, *supra* note 35, at 1510-21. Barnard's article actually recommended a seventh factor as well, but the court, without explanation or comment, did not include it. *Shah*, 1993 U.S. Dist. LEXIS 10347, at *20. The seventh factor was "The Defendant's Appreciation of an Executive's Fiduciary Obligations." *See* Barnard, *supra* note 35, at 1521-22.

79. *See, e.g.*, SEC v. Bonastia, 614 F.2d 908, 912 (3d Cir. 1980); *supra* note 27.

80. *Patel*, 1994 U.S. Dist. LEXIS 9479, at *12-14; *Shah*, 1993 U.S. Dist. LEXIS 10347, at *20-22.

81. SEC v. Patel, 61 F.3d 137, 142 (2d Cir. 1995).

82. *Id.* at 141 ("[T]he district court properly took into account the six factors that it identified in evaluating substantial unfitness. These factors are useful in making the unfitness assessment, although we do not mean to say that they are the only factors that may be taken into account or even that it is necessary to apply all these factors in every case. A district court

II court focused particularly on the defendant's repeat offender status and the likelihood of recurrence.[83] The court stated that, "[a]lthough it is not essential for a lifetime ban that there be past violations, we think that it is essential, in the absence of such violations, that a district court articulate the factual basis for a finding of the likelihood of recurrence."[84]

Furthermore, the *Patel II* court read the bar statute to suggest that a court pondering the imposition of a permanent bar should first consider whether a conditional or temporary bar would be more appropriate, especially when there is no prior history of unfitness.[85] In other words, without such prior violations, courts should not permanently bar defendants unless courts can articulate both (a) a factual reason to think that the defendant is likely to repeat his fraud, and (b) a reason that a conditional or temporary bar is insufficient to prevent a future violation. The *Patel II* court's six-factor test and its added scrutiny for first-time offenders made permanent bars quite difficult for the SEC to obtain.

The six-part test used in *Patel II* was also adopted by the Ninth Circuit Court of Appeals.[86] The test has now been embraced by every court that has considered the matter,[87] and was followed as recently as July 16, 2002—two weeks before Sarbanes-Oxley was signed into law.[88] It remains to be seen whether the passage of Sarbanes-Oxley

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should be afforded substantial discretion in deciding whether to impose a bar to employment in a public company.")

83. *Id.* at 141-42.

84. *Id.* at 142.

85. A conditional bar might be one limited to a certain industry, while a temporary bar would be limited to a fixed period of time. *Id.* The Second Circuit noted that the statutes provide that a bar may be imposed "conditionally or unconditionally" and "permanently or for such a period of time as [the court] shall determine." *Id.* From that language, the court concluded that the legislature intended that a court should consider whether a conditional or limited bar is sufficient before imposing a permanent bar, especially where there is no prior history of unfitness. *Id.*

86. *See* SEC v. First Pac. Bancorp, 142 F.3d 1186, 1193 (9th Cir. 1998).

87. Jayne W. Barnard, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: The SEC's Suspension and Bar Powers in Perspective*, 76 TUL. L. REV. 1253, 1259-60 (2002).

88. SEC v. Robinson, No. 00 Civ 742, 2002 U.S. Dist. LEXIS 12811, at *15 (S.D.N.Y. July 16, 2002). The SEC alleged that Mr. Robinson obtained at least $400,000 from investors by fraudulently representing that that his company's sales of "mobile wireless digital personal security alarm systems for cars" were estimated to grow to $44 billion by 2005 even though the company had no product, no financing, and no manufacturing contract. *Id.* at *2. Following the six-part test from SEC v. Patel, 61 F.3d 137 (2d Cir. 1995), the *Robinson* court found Robinson's flagrant misrepresentations, repeat offenses, scienter, and likelihood of future offenses warranted that he should be permanently barred from serving as an officer or director of any public company. *Id.* at *14-20.

will cause courts to reexamine the six-factor test for officer and director suspension.

Not surprisingly, certain SEC staff members have complained that the judicial standard makes it too difficult to bar corporate wrongdoers.[89] The judicial standard for "substantial unfitness" adopted by *Patel II* and followed by subsequent courts is a high one. In February of 2002, Stephen M. Cutler, Director of the Division of Enforcement at the SEC, argued that the statutory scheme that allows only federal courts, and not the SEC, to impose officer and director bars was inadequate.[90] Cutler also asserted that case law has created a "burdensome and overly restrictive test" that places an "unreasonably high" burden of proof on the SEC.[91] For a number of years, therefore, the SEC has pushed for lower standards for permanent suspensions and for the authority to issue suspension orders without going through the federal courts.[92]

III. CHANGES TO SUSPENSION ACTIONS WROUGHT BY SARBANES-OXLEY

A. *The House of Representatives Bill*

On April 24, 2002, the House of Representatives passed a draft of the bill that would eventually become the Sarbanes-Oxley Act.[93] In its section on officer and director bars, the House draft tracked, for the most part, the judicial standard for substantial unfitness from *Patel II*.[94] The House's draft, however, would have made enforcement by the SEC easier in two important ways. First, the House version's explanation of what constitutes substantial unfitness contained only five of the six elements of the *Patel II* test, dropping the repeat offender consideration.[95] Second, and more importantly, the House

89. Barnard, *supra* note 87, at 1253-54.

90. Cutler, *supra* note 29.

91. *Id.* ("When confronted with [several cases in which courts refused to impose permanent officer and director bars in spite of egregious conduct by the defendants], it is hard for me, at least, to avoid tbe conclusion that, when it comes to O and D bars, the courts have simply lost their way. . . . In today's complex economy and volatile market, a single, serious breach of the public trust, in my view, undeniably renders one 'substantially unfit' for service as an officer or director. The layering on of additional tests simply frustrates the goals of the statute and endangers the interests of the investing public.").

92. *See* Barnard, *supra* note 87, at 1255-56.

93. 148 CONG. REC. H1544 (daily ed. Apr. 24, 2002).

94. *Id.* at H1561.

95. *Id.*

bill allowed the SEC to bring an action directly, without going through the courts.[96]

Section 11(a) of the House bill gave the SEC authority, in any cease-and-desist proceeding, to prohibit violators of securities laws from serving as officers or directors.[97] The standard that the SEC had to meet was essentially the same as that set forth in the Remedies Act: violation of securities fraud laws and conduct that demonstrated substantial unfitness to serve as an officer or director.[98] However, section 11(b) of the bill provided, for the first time, a statutory test for a finding of substantial unfitness:

> (b) Finding of Substantial Unfitness. In making any determination that a person's conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer, the Commission shall consider
>
> (1) the severity of the person's conduct giving rise to the violation, and the person's role or position when he engaged in the violation;
>
> (2) the person's degree of scienter;
>
> (3) the person's economic gain as a result of the violation; and
>
> (4) the likelihood that the conduct giving rise to the violation, or similar conduct as defined in subsection (a), may recur if the person is not so prohibited.[99]

The four-part statutory test is almost identical to the six-part *Patel II* test. The only differences are that two elements are combined in part one and that the repeat offender element is eliminated. By eliminating the repeat offender element, this bill probably would have eliminated the *Patel II* court's apparent presumption against permanently suspending first-time offenders.

B. Representative LaFalce's Critique

United States Representative Michael G. Oxley (R. Ohio), chairman of the House Financial Services Committee, was the sponsor of the House draft. Not everyone agreed that the draft was an improvement over the existing standard for officer and director bars. Representative John LaFalce (D. New York) argued that, by codifying the case law standard, the bill only strengthened an unnecessarily high standard for such bars.[100] Representative LaFalce argued that

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96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.*
100. 148 CONG. REC. H1583 (daily ed. Apr. 24, 2002).

> The SEC said that existing case law makes it virtually impossible for them to do this, to bar unfit officers and directors. And what have the Repuhlicans done? They have taken that bad case law and codified it. In that respect the Republican bill is worse than the status quo.[101]

Representative LaFalce wanted the Republican-sponsored bill to go farther to make it easier to obtain officer and director suspensions, but his comments were an overstatement. He failed to mention either that the Republican bill gave the SEC the power to bar persons directly or that the repeat offender part of the test had been removed.[102] Representative LaFalce offered a substitute bill that would have changed "substantial unfitness" to "unfitness" and left the term undefined.[103] The LaFalce substitute bill was rejected by a vote of 219 to 202,[104] and Representative Oxley's bill was adopted by the House instead.[105]

C. The Senate Bill

The Senate version of what became the Sarbanes-Oxley Act initially did not give the SEC administrative authority to issue officer and director bars.[106] On July 10, 2002, then Senate minority leader Trent Lott (R. Miss.) offered an amendment regarding officer and director bars that was almost identical to the one previously proposed by Representative LaFalce in the House.[107] Senator Lott's Amendment allowed the SEC to issue a bar order in a cease-and-desist proceeding, and it also changed the standard from "substantial unfitness" to "unfitness."[108] During the Senate discussion, Senator Lott explained the need for his amendment:

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101. *Id.*

102. *Id.*

103. *Id.* at H1580.

104. *Id.* at H1588-89.

105. *Id.* at H1592. The vote was 334-90. *Id.*

106. The first version was introduced June 25, 2002 by Senator Paul S. Sarbanes (D. Md.). 148 CONG. REC. S6013 (daily ed. June 25, 2002).

107. *See* 148 CONG. REC. S6543 (daily ed. July 10, 2002).

108. *Id.* Senator Lott's bar provision added the following subsection to 21C of the 1934 Act and a parallel version for section 8A of the 1933 Act:

> Authority of the Commission to Prohibit Persons From Serving as Officers or Directors. In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 10(b) of this title or the rules or regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to section 15(d) of this title if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer.

Id.

> Under current law, only a Federal court can issue an order prohibiting a person from acting as an officer or director of a public company. The SEC cannot order this remedy in its own administrative cease-and-desist proceedings. . . . This section would grant the SEC authority to issue such orders if a person had committed a securities violation and his or her conduct demonstrated unfitness to serve as an officer or a director.[109]

The Lott amendment was passed by a vote of 97-0[110] and was included in the final version of the Senate bill, which passed 76-0.[111]

D. Final Version of the Act

The final version of the Sarbanes-Oxley Act adopted the language that Representative LaFalce and Senator Lott had recommended concerning officer and director bars. Section 305 of Sarbanes-Oxley changed the judicial standard from "substantial unfitness" to "unfitness" without defining either term,[112] and section 1105 gave the SEC authority to bar people from serving as officers and directors even in the absence of an order by a federal court.[113]

> The parallel version for section 8A of the 1933 Act had almost the same language and simply referred to violations of 17(a)(1) rather than section 10(b).

Id.

109. *Id.* at S6545.

110. *Id.* at S6551.

111. 148 CONG. REC. S6779 (daily ed. July 15, 2002).

112. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 305, 116 Stat. 745, 778-79 (codified at 15 U.S.C. § 77h-1(f)). This section reads

> Sec. 305. OFFICER AND DIRECTOR BARS AND PENALTIES.
>
> (a) Unfitness Standard.—
>
> (1) Securities exchange act of 1934.— Section 21(d)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)(2)) is amended by striking "substantial unfitness" and inserting "unfitness".
>
> (2) Securities act of 1933.— Section 20(e) of the Securities Act of 1933 (15 U.S.C. 77t(e)) is amended by striking "substantial unfitness" and inserting "unfitness".
>
> (b) Equitable Relief.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended by adding at the end the following:
>
> "(5) Equitable Relief.— In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."

Id.

113. § 1105, 116 Stat. at 809-10. This section reads

> Sec. 1105. AUTHORITY OF THE COMMISSION TO PROHIBIT PERSONS FROM SERVING AS OFFICERS OR DIRECTORS.
>
> (a) Securities Exchange Act of 1934.—Section 21C of the Securities Exchange Act of 1934 (15 U.S.C. 78u-3) is amended by adding at the end the following:
>
> "(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors.—In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 10(b)

Sarbanes-Oxley also amended section 21(d) of the Securities Exchange Act of 1934 to provide that a federal court may grant "any equitable relief that may be appropriate or necessary for the benefit of investors."[114] This equitable relief section does not appear to add anything new, but simply codifies the federal courts' broad power to grant equitable relief.[115]

While the change from "substantial unfitness" to "unfitness" indicates that Congress considered the current standard too high, Congress has left it to the SEC and the federal courts to decide what the new standard should be. This could have unintended consequences in either of two ways. On one hand, courts could completely reject the six-part test from *Patel II* and allow the SEC to issue officer and director bars almost any time securities laws have been violated. On the other hand, courts could interpret the change to be only a slight adjustment, and thus continue to apply the existing test with only a slight increase in strictness.[116] In the future, it will become clear how courts interpret the deletion of the word "substantial," and whether the SEC's expanded cease-and-desist powers cause it to issue officer and director bars more aggressively.

E. Likelihood That Officer and Director Suspensions Will Be Used More Frequently

There are a number of reasons to think that the officer and director bar provision will become much more prevalent and important to securities law enforcement. Courts have been able to bar

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> or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12, or that is required to file reports pursuant to section 15(d), if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer."
>
> (b) Securities Act of 1933.—Section 8A of the Securities Act of 1933 (15 U.S.C. 77h-1) is amended by adding at the end of the following:
>
> "(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors.—In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 17(a)(1) or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934, or that is required to file reports pursuant to section 15(d) of that Act, if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer."

Id.

114. 15 U.S.C. § 78u(d)(5) (Supp. 2003).

115. *See, e.g.*, SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972).

116. The SEC could attempt to bypass the federal courts by using cease-and-desist orders for officer and director bars, but these orders can always be appealed to the courts. Thus, the judicial standard is ultimately the standard that the SEC will have to follow.

corporate wrongdoers from serving as officers and directors for some time, but the high judicial standard and the requirement that these bars be issued by federal judges have resulted in relatively few such bars to date.[117] However, because Sarbanes-Oxley authorizes the SEC to suspend directors and officers directly and lowers the requisite standard, the SEC may find suspension to be one of its more effective tools for deterring corporate fraud and stopping repeat offenders.

Further, the increased political pressure created in the wake of 2002's corporate scandals, may increase the prevalence of officer and director suspension. As an example of this political pressure, a 127-page report by the Senate Governmental Affairs Committee in October 2002 sharply criticized the SEC for its failure to catch the financial fraud at Enron before it brought down the company.[118] The report found "systemic and catastrophic failure" by the SEC in its investigations and noted that the SEC failed to even review any of Enron's annual reports after 1997.[119] In addition to congressional pressure, the media scrutiny that has followed the agency throughout the corporate scandals and the mishaps of former SEC chairman Harvey Pitt are likely to force the SEC to take an aggressive approach to neutralizing dishonest directors and officers.[120]

The clearest indication that officer and director bars will be used more frequently comes from remarks made by the director of the Division of Enforcement at the SEC. In a February 15, 2002 speech,[121] Director Stephen M. Cutler made it clear that, in spite of his frustration with the judicial standard in *Patel II* and other cases, he was "steadfastly determined to be more aggressive in seeking officer and director bars."[122] Cutler also cited the statistical increase in the SEC's suspension activities in recent years. He noted that in fiscal year 2000 the Commission sought fourteen officer and director bars, whereas in 2001 the SEC sought more than twice that number.[123] Cutler anticipated that the trend would continue upward in the future.[124]

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117. *See supra* note 29 and accompanying text.

118. *See* Jonathan Weil & John Wilke, *Probe by Senate Says SEC Failed in Enron Case*, WALL ST. J., Oct. 7, 2002, at C1.

119. *Id.*

120. *See SEC Chief Resigns Under Fire: White House Relieved; Successor to Pitt Won't Be Named Right Away*, SEATTLE TIMES, Nov. 6, 2002, at E1 (summarizing the actions and political fall-out that resulted in Pitt's resignation).

121. This was about five months prior to the final passage of Sarbanes-Oxley.

122. Cutler, *supra* note 29.

123. *Id.* (noting that the SEC sought a total of 33 officer and director bars in 2001).

124. *Id.*

IV. MARKET FACTORS AND OTHER LAWS REDUCE THE NEED FOR OFFICER & DIRECTOR SUSPENSION

Sarbanes-Oxley clearly gave the SEC greater power to bar individuals from serving as officers or directors of publicly traded companies. It is less clear, however, whether these changes are either helpful in or necessary for protecting the investing public. Most (though not all) corporate misconduct can be prevented more effectively in ways other than SEC suspensions. Although this Note argues that the suspension provisions do fill an important gap, most corporate offenses can be prevented more effectively by market forces, new rules by the national exchanges, and the toughening of criminal sanctions brought about by Sarbanes-Oxley.

A. Market Forces Should Reduce Repeat Corporate Offenses

Market forces may be much more effective than any SEC suspension in preventing repeat offenses by corporate criminals. The stock market responds swiftly to allegations of corporate fraud, especially after the Enron debacle and other similar scandals.[125] In his testimony before the House Committee on Financial Services on March 13, 2002, James Glassman argued against certain provisions in Sarbanes-Oxley, pointing out that investors can effectively punish bad behavior by corporate leadership and that short sellers have an incentive to expose corporate wrongdoing.[126] Of course, it is important to note that the stock market does not directly discipline officers and directors. A stock price decline punishes investors; it does not, at least directly, punish officers and directors.[127] A stock market decline in response to corporate wrongdoing will only directly motivate directors and officers to the extent that they are investors, have stock options, or rely on strong stock performance for their job security.

Because stock price declines may cause more loss to shareholders than to officers and directors, shareholders have a

125. *See* 148 CONG. REC. H1585 (daily ed. Apr. 24, 2002) (statement of Rep. Toomey) ("I think part of the problem with the substitute is an underlying failure to appreciate the ability of the marketplace to impose some discipline as well. But we have already seen how severely and appropriately investors have responded to companies who have even questionable accounting practices after this Enron debacle.").

126. James K. Glassman, *Capital Punishment*, Tech Central Station (Mar. 14, 2002), *at* http://www.techcentralstation.com/031402D.html.

127. *See* 148 CONG. REC. H1588 (daily ed. Apr. 24, 2002) (statement of Rep. LaFalce) ("[T]he magic of the marketplace, you say the marketplace will punish. The marketplace punishes investors. It does not punish the wrongdoers. You have got it wrong."). However, depending on the strength of corporate governance controls, a significant drop in stock price could very well cause executive officers to be replaced.

natural incentive to push for the hiring of officers and directors who will increase share value rather than those who will pillage the company through securities fraud and other wrongdoing.[128] In theory at least, shareholders control the corporation through electing directors who, in turn, hire officers.[129] Shareholders can thereby make sure that only officers and directors with clean records are hired. Federal securities law ensures that shareholders are informed about the recent criminal history of potential officers and directors. Regulation S-K section 401(f) requires that annual proxy statements disclose certain "events" of the past five years that are material to the competency or integrity of any executive officer, director, or director nominee.[130] Events that are material include criminal convictions, entry of orders enjoining participation in the financial-services industry, and adjudicated violations of federal securities laws.[131] With this information, shareholders should be able to prevent the hiring of securities law violators who would harm the company. Finally, even if some bad actors are inadvertently hired, shareholders can always seek redress through shareholder derivative lawsuits.[132]

B. New Listing Requirements Should Help Prevent Abuse and Neglect by Directors and Officers

Another factor that should reduce corporate wrongdoing, regardless of suspension orders or other SEC action, is the new corporate governing standards for listed companies that have been adopted by the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") (collectively, the "National Exchanges"[133]). On August 16, 2002, the NYSE submitted for SEC approval new

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128. Some argue that for this reason, and as a matter of public choice, removal of officers and directors is more appropriate by shareholders than by tbe SEC. *See* Barnard, *supra* note 29.

129. Shareholders can not only elect directors, but can also remove them—with or without cause in some states. MODEL BUS. CORP. ACT § 8.08(a) (2002). Likewise, directors can remove officers at any time with or without cause. § 8.43(b). Therefore, shareholders should have the ability to discipline directors and to pressure directors into controlling the behavior of officers. However, Part V.A will question the assumption that shareholders actually and effectively control corporations.

130. 17 C.F.R. § 229.401(f) (2003).

131. *Id.*

132. *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 395-97 (1999) (discussing the right of individual shareholders to bring a derivative lawsuit on behalf of the corporation against management for breaches of fiduciary duty).

133. Technically Nasdaq is not an "exchange" under the Securities Exchange Act of 1934. However, Nasdaq has applied to obtain qualification as an exchange. SEC Shortly To Turn Full Attention to NASDAQ Application for Exchange Status, 35 Sec. Reg. & L. Rep. (BNA) 1040 (June 23, 2003).

requirements for listed companies. Nasdaq did likewise on November 20, 2002.[134] After a period for public comment, the proposed listing standards by the National Exchanges were adopted by the SEC and became effective on November 4, 2003.[135] These new standards could become a much more effective method of promoting corporate integrity and accountability than the solutions implemented by Congress in Sarbanes-Oxley.

The listing standards require that a majority of corporate board members be independent and that certain committees be entirely independent.[136] The definition of "independence" has been tightened so that individuals who work for a company within the previous five years (three years for Nasdaq) and certain members of an interlocking directorate[137] are presumed not independent.[138] Furthermore, nonmanager directors have to meet on a regular basis, and shareholders have been given the right to vote on all executive stock-option plans.[139] Violations of some of these and other new rules could result in a public reprimand letter or even delisting of the company.[140]

These listing requirements should, to some extent, make corporate boards of directors more independent of management. This should improve the monitoring of officers by directors and reduce instances of "captive boards" that capitulate to every officer request and turn a blind eye to officer wrongdoing. Considering that almost all large public firms are traded on either Nasdaq or the NYSE, these changes should have a far-reaching effect. The increased board independence, direct shareholder involvement, and greater disclosure may provide some of the accountability and deterrence that was sought by Sarbanes-Oxley's suspension provisions.

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134. NASDAQ, SUMMARY OF NASDAQ CORPORATE GOVERNANCE PROPOSALS AS OF FEBRUARY 26, 2003 (2003) (revising the earlier November 20, 2002 proposals), http://www.nasdaq.com/about/Web_Corp_Gov_Summary%20Feb-revised.pdf; NEW YORK STOCK EXCHANGE, CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS AUGUST 1, 2002 (2002), http://www.nyse.com/pdfs/corp_gov_pro_b.pdf.

135. NASD and NYSE Rulemaking: Relating to Corporate Governance, Excbange Act Release No. 34-48745 (Nov. 4, 2003), http://www.sec.gov/rules/sro/34-48745.htm; NASDAQ, *supra* note 134, at 1; NEW YORK STOCK EXCHANGE, *supra* note 134, at 1.

136. NASDAQ, *supra* note 134, at 2; NEW YORK STOCK EXCHANGE, *supra* note 134, at 5-10.

137. An interlocking directorate exists where an officer of company A sits on the board of company B, and at the same time an officer of company B sits on the board of company A.

138. NASDAQ, *supra* note 134, at 2; NEW YORK STOCK EXCHANGE, *supra* note 134, at 6.

139. NASDAQ, *supra* note 134, at 1-2; NEW YORK STOCK EXCHANGE, *supra* note 134, at 6, 13.

140. NASDAQ, *supra* note 134, at 4-5; NEW YORK STOCK EXCHANGE, *supra* note 134, at 17-18; *see also* Garrison D.B. Alexander, *Proposed NYSE Listing Standards* (Aug. 20, 2002), *at* http://www.thelenreid.com/articles/article/art_137.htm.

C. Civil and Criminal Penalties Deter Corporate Fraud

One may justify the increase in the SEC's officer and director bar powers by pointing out the deterrent effect that such power would have on potential wrongdoers. If deterrence is the goal, however, other changes wrought by Sarbanes-Oxley may be more appropriate and effective. The Sarbanes-Oxley Act stiffens criminal penalties for both violators of the securities laws and other white-collar criminals.[141] The Act increases the criminal penalty for violations of the Securities Exchange Act from "$1,000,000, or imprison[ment of] not more than 10 years" to "$5,000,000, or imprison[ment of] not more than 20 years."[142] The Act also requires CEOs or CFOs to certify financial statements and face fines or jail time if they know those statements to be false.[143] Moreover, the Act calls on the United States Sentencing Commission to enhance penalties for securities fraud and related offenses in order to "ensure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offenses."[144]

In addition to being a more effective deterrent than the threat of a permanent bar, the stiffer criminal penalties provided by Sarbanes-Oxley may also be the more appropriate remedy. Injunctions by the SEC are designed to regulate conduct rather than to punish.[145] Although in many instances agencies are authorized to issue civil penalties, those penalties are not to be "so punitive in either purpose or effect" that they become de facto punishments.[146] Because criminal penalties are designed partially to punish and deter, there is a strong argument that Sarbanes-Oxley's criminal provisions are more appropriate than its suspension provisions for going after corporate wrongdoers.

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141. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 405-06, 1104, 1106, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-7266).

142. § 1106.

143. § 906(a).

144. § 1104(a), (b)(1).

145. *See* Barnard, *supra* note 29, at 70.

146. U.S. v. Ward, 448 U.S. 242, 248-49 (1980). However, that is not to say that it is uncommon for civil penalties to be used as de facto punishments.

V. THERE IS STILL A NEED FOR OFFICER AND DIRECTOR SUSPENSIONS

Market forces, tougher standards by the National Exchanges, and the threat of civil and criminal penalties should all prevent corporate wrongdoing far more effectively than permanent suspension of officers and directors by the SEC. Nevertheless, because of the realities of corporate governance, shareholders, National Exchanges, and criminal laws often exercise only limited control over executives. In situations where those forces fail, permanent suspension of officers and directors may be the best form of protection for the investing public.

A. Where Market Forces and National Exchange Listing Standards Are Not Effective

In most circumstances, shareholders will resist the hiring of an officer or director with a history of securities fraud because they will not trust such an individual to put the company's interests first and to maximize shareholder value. However, there are some circumstances in which an executive's criminal background may actually demonstrate the opposite—i.e., that the executive is willing to do everything it takes to maximize shareholder value, even if it involves illegal conduct.[147] An executive who is fiercely dedicated to raising his company's stock price even if it means breaking the law may be just the type of person that shareholders would like to hire, especially shareholders who do not intend to hold onto their stock for a long period of time.[148] Since this sort of executive would be perceived as being more loyal to the company than to the law, and hence more likely to steal *for* the company than steal *from* it, he might be rehired even after being convicted of a corporate crime.[149] Under such circumstances, an officer or director bar may not be necessary to protect a specific company's shareholders, but it would be vital to

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147. Martin McDermott describes two broad categories of corporate crime: occupational crime—which is committed by an individual in connection with his occupation and is done for personal benefit—and organizational crime, which encompasses crimes committed by businesses and employees to further the primary, legitimate purposes of the organization. Martin F. McDermott, *Occupational Disqualification of Corporate Exccutives: An Innovative Condition of Probation*, 73 J. CRIM. L. & CRIMINOLOGY 604, 605-06 (1982). It is the latter type, organizational crime, which is less likely to be punished by the market and hence is more likely to require permanent suspension.

148. *See* Morris, *supra* note 37, at 208.

149. *See* Stanton Wheeler et al., *White Collar Crimes and Criminals*, 25 AM. CRIM. L. REV. 331, 352 (1988); *see also* Barnard, *supra* note 35, at 1500.

protect the market as a whole.[150] Even when they do not harm a particular corporation's shareholders, violations of rules regarding securities fraud may still cause harm to traders on the other side of the transaction, damage the reputation of the stock market, harm creditors, and have a negative impact on market liquidity.[151]

Even when shareholders do not want to hire executives with a history of securities fraud, they may not always have the power to prevent such hires.[152] Although, in theory, shareholders elect directors who appoint officers, in reality, the process is often reversed: ultimate power resides in officers rather than shareholders. Strong CEOs often decide who will be nominated as directors, and shareholders have no real choice but to elect the single slate of directors nominated. E.J. Epstein noted that, in 1984, "out of some six thousand corporate elections of boards of directors, only eight offered shareholders the possibility of voting for an alternate board of directors, and in only three of these contests did the challenger manage to win control through proxy solicitation."[153] Epstein went on to argue that "shareholder suffrage is a myth perpetuated primarily by marketers at the New York Stock Exchange."[154] The corporate governance requirements proposed by the National Exchanges may shift the balance of power more towards shareholders in the future, but that remains to be seen.

There are, therefore, at least two situations in which market forces are likely to be insufficient for preventing corporate fraud. The first is when shareholders have an incentive to hire executives who may be able to boost their short-term share price but could harm the securities market as a whole. The second is when shareholders lack the power to prevent persons with prior convictions from being hired

150. *See* Morris, *supra* note 37, at 208 n.259 (citing *Securities Law Enforcement: Hearing on H.R. 975 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong. 75 (1989) (statement of David S. Rider, former Chairman of the SEC)).

151. Recent empirical research indicates that illegal insider trading has a negative impact on liquidity. *See* Raymond P.H. Fishe & Michel A. Robe, *The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence from a Natural Experiment*, J. FIN. MARKETS at 3 (2002), http://som.yale.edu/jfm/ProgramPDFs/BWPaperv11b.pdf.

152. It is not unheard of for persons with a history of corporate crime being rehired as important executives. *See, e.g.*, Barnard, *supra* note 35, at 1500 nn.56-58 (citing several instances of executives who became presidents of prominent companies after being convicted of crimes including embezzlement).

153. E.J. EPSTEIN, WHO OWNS THE CORPORATION 15 (1986).

154. Barnard, *supra* note 29, at 64, n.216 (summarizing Epstein's argument from WHO OWNS THE CORPORATION).

as officers or directors of the corporation.[155] In situations where perpetrators of corporate fraud might be rehired for either of the above reasons, a permanent bar by the SEC may be the best way to protect securities markets.

B. Where Criminal and Civil Penalties are Not Effective Deterrents

Like market forces, criminal and civil penalties may not always provide the same degree of protection for securities markets as permanent bars. Criminal and civil penalties deter corporate fraud by means of fines and jail sentences. However, in the context of white-collar crime, both fines and jail sentences may have only a modest deterrent effect and may need to be supplemented by the threat of a permanent suspension.

Monetary penalties may be imposed on dishonest executives in any of three ways: criminal fines, civil fines, and civil judgments. Awards against directors in fiduciary duty lawsuits may be massive,[156] and controlling persons who commit insider trading can be fined up to the greater of $1 million or three times their profits, in addition to orders of disgorgement or criminal fines.[157] However, indemnification contracts, corporate by-laws, and insurance contracts can shift the responsibility for payment of these fines from executives to shareholders.[158] Thus, many "large judgments [are ultimately] payable in the last analysis [not by officers and directors but] by innocent investors, for the benefit of speculators and their lawyers."[159] Fiduciary duty of loyalty claims and other intentional or criminal wrongdoings are generally not covered by indemnification or insurance.[160] However, the large salaries, bonuses, and severance

155. This would presumably be more likely where the convicted person has personal or business ties to current officers and directors.

156. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Directors reportedly settled this duty of care case for $23,500,000, though it appears that they personally paid little if any of that amount. O'KELLEY & THOMPSON, *supra* note 132, at 307.

157. O'KELLEY & THOMPSON, *supra* note 132, at 1192 (discussing the Insider Trading and Securities Fraud Enforcement Act of 1988).

158. State statutes allow corporations to indemnify officers and directors for breach of fiduciary duty of care (but not breach of fiduciary duty of loyalty). *See* Del. Code Ann. Tit. 8, § 145(a), (b) (2001); MODEL BUS. CORP. ACT § 8.59 official cmt. (2002).

159. SEC v. Tex. Gulf Sulpher Co., 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (Friendly, J., concurring).

160. State statutes prohibit indemnification for illegal acts by executives. *See* NEW YORK BUS. CORP. LAW § 721 (McKinney 2003), *available at* http://www.law.cornell.edu/ny/statutes/buscorp.htm#A7.

packages that are paid to many corporate executives can make the monetary fines seem trivial.[161]

While indemnification may prevent fines from truly impacting the alleged wrongdoer, permanent suspension cannot be so easily avoided. An executive who is permanently barred from the corporate suite will almost certainly not be able to earn as much money in the future. Therefore, although permanent suspension is primarily about preventing future fraud, it also imposes a serious monetary cost on the wrongdoer.[162]

The threat of jail may also be a less than ideal deterrent in the context of white-collar crime. Corporate executives would certainly want to avoid being sent to jail, but there is a common perception that few white-collar criminals actually serve time. If they do, it is likely to be fairly short; the median prison sentence for defendants convicted of securities fraud is only twelve months.[163] A permanent suspension, on the other hand, would not be so transitory.[164] Of course, most people would be more intimidated by the threat of jail than the threat of suspension, but if the possibility of jail seems remote, and an ambitious executive is still in the early stages of her career, permanent suspension may be more daunting.

Thus, although civil and criminal penalties are usually an effective way to prevent corporate wrongdoing (especially after Sarbanes-Oxley's stiffening of corporate criminal penalties), an additional remedy may sometimes be needed. There are situations where civil and criminal penalties fail and where officer and director suspension can fill an important gap. When corporate offenders are shielded from civil and criminal penalties through indemnification and lenient law enforcement, officer and director bars may be the best means to deter and prevent future corporate crimes.

Deterrence is typically associated with punishment, and punishment is not properly the purpose of SEC injunctions. But if an

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161. *See* McDermott, *supra* note 147, at 616 (discussing "informal indemnification" in the form of added benefits and bonuses).

162. *Id.* at 615-16.

163. Barnard, *supra* note 35, at 1522 n.170 (citing DAVID WEISBURD ET AL., CRIMES OF THE MIDDLE CLASSES: WHITE COLLAR OFFENDERS IN THE FEDERAL COURTS 131 (1991)). It remains to be seen whether or not Congress's recommendations to the Sentencing Commission in sections 905 and 1104 of the Sarbanes-Oxley Act will have a significant effect on the median sentence. The recent seven year jail sentence imposed on former ImClone CEO Sam Waksall for insider trading may indicate a trend toward more aggressive prosecution of securities violations in the future. *See* Matthew Benjamin, *The Wages of Sin: ImClone Founder Sam Waksal's Sentence Signals Tough Times Ahead for Corporate Criminals*, U.S. NEWS & WORLD REP., June 23, 2003, at 30.

164. Barnard, *supra* note 35, at 1522 n.170 (citing WEISBURD ET AL., *supra* note 163, at 131).

SEC suspension is issued primarily to prevent repeat corporate crimes, perhaps it is acceptable that suspension also has, as a by-product, a deterrent or even punitive effect.[165] Defendants are still able to seek work in a private firm or a nonexecutive-level job in a public corporation.[166]

C. High Rate of White-Collar Criminal Recidivism Indicates Need for Suspension

Empirical studies that show a high rate of recidivism among white-collar criminals also indicate the need for permanent suspension in some cases. A 1988 study by Wheeler, Weisburd, Waring, and Bode found that white-collar criminals had a surprisingly high number of prior arrests.[167] Although the rates were not as high as for common criminal defendants, the study found that forty-six percent of white-collar offenders had a prior arrest, and thirty-four percent had a prior conviction.[168] Securities fraud offenses, even more than most other white-collar crimes, were especially likely to be "patterned and repetitive."[169]

Professor Barnard argues that a temporary or limited suspension is always preferable to a comprehensive lifetime suspension.[170] However, there does not appear to be any real assurance that people who systematically break securities laws can be trusted after a certain number of years. On the contrary, there is anecdotal evidence of executives who committed fraud a number of years after their first offense. For example, in 1971, Robert Maxwell, president of Pergamon Press, was temporarily barred from company management under a British suspension statute.[171] Twenty years

165. *See* McDermott, *supra* note 147, at 624 ("[C]ourts routinely impose remedies which, in effect, penalize violations of civil statutes to deter third parties from similar conduct, even though equity has traditionally forbidden forfeitures or imposition of decrees with penal purposes.").

166. The SEC's suspension powers apply only to officers and directors (as opposed to lower level employees) of publicly traded companies (as opposed to private firms). 15 U.S.C. §§ 77t(e), 78u(d) (2000).

167. Wheeler et al., *supra* note 149, at 342.

168. *Id.* The rate of prior convictions for those found guilty of securities fraud was 27.6%. *Id.* at 345.

169. *Id.* at 343. In another study of people whom the SEC had investigated for securities fraud violations, at least half had been investigated on one or more previous occasions—most often for securities fraud. Barnard, *supra* note 35, at 1518 n.154 (citing SUSAN P. SHAPIRO, WAYWARD CAPITALISTS 39 (1984)).

170. Barnard, *supra* note 29, at 34.

171. *See* Barnard, *supra* note 35, at 1502 n.65 and accompanying text (citing Peter J. Boyer, *Maxwell's Silver Hammer*, VANITY FAIR, June 1991, at 112, 180).

later, after successfully restarting his career, Maxwell was found to have looted the pension funds at his new company.[172] Although it is hard to imagine that Jeff Skilling, Enron's former CEO, would be rehired in the near future, it does not seem unlikely that less infamous perpetrators of securities fraud could return after a ten-year hiatus and again commit crimes on the market. Therefore, a temporary or limited bar may not always be sufficient.

Many white-collar criminals, and perhaps securities fraud violators in particular, are likely to commit crimes again even after a conviction. Because of the relatively high rate of recidivism and because market forces and criminal penalties sometimes are not enough, permanent bars rather than temporary suspension may sometimes be the only way to prevent repeat offenses that rob others and damage securities markets.

VI. OTHER CONSIDERATIONS

While permanent officer and director bars may sometimes be the only way to adequately discourage corporate wrongdoing, it is important to also consider the potential costs of the increased SEC bar powers. Two specific concerns that have been raised are the possibility that the SEC will abuse its bar powers and the potential that those powers (as well as other provisions in Sarbanes-Oxley) will severely deplete the pool of people who are willing to serve as directors.

A. Possibility that the SEC Will Abuse Its Bar Powers

The lower unfitness standard and grant of power to the SEC to order permanent bars in cease-and-desist orders could result in abuse of executive bars. When the SEC issues a permanent suspension through a cease-and-desist proceeding, the agency is acting as investigator, prosecutor, and judge.[173] It is therefore understandable

172. *Id.* (citing Nicholas Bray, *Securities Lending in UK Dealt Blow by Maxwell Affair*, WALL ST. J., Dec. 9, 1991, at A10).

173. However, there is some separation within the SEC. SEC staff act as investigators, whereas SEC commissioners (appointed by the president and confirmed by the Senate) act as judge and jury. 15 U.S.C. § 78d(a) (2000) ("There is hereby established a Securities and Exchange Commission . . . to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate."); *see also* San Francisco Mining Exch. v. SEC, 378 F.2d 162, 167 (9th Cir. 1967) (stating that the SEC was not hiased and had not prejudged the case simply because it had relied upon a report by SEC staff).

that some critics are concerned about defendants' due process rights.[174]

While concerns about potential abuses by the SEC are valid,[175] a number of safeguards should mitigate the risk that the SEC will abuse its new authority. First, and most importantly, even though the SEC can issue officer and director bars directly through a cease-and-desist proceeding, defendants always retain the ability to appeal agency rulings to the federal courts.[176] Second, suspension is a remedy that is only available to the SEC, and not to private parties.[177] If the bar orders that the SEC has sought in the past are any guide to the agency's future actions, it seems likely that only those executives who commit egregious violations will be permanently barred.[178] Third, suspension cannot be imposed on people who only innocently or negligently violate a provision of the securities laws. A defendant has to be in breach of one of the antifraud provisions of the securities laws to be suspended,[179] and the antifraud provisions are usually not triggered unless the defendant demonstrates scienter (as opposed to mere negligence).[180] Thus, there are enough safeguards in place so that due process concerns should not outweigh the benefits provided by the SEC's bar powers.[181]

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174. Barnard, *supra* note 29, at 72. Barnard is also concerned, perhaps even more so, that permanent suspension interferes with the due process rights of shareholders to choose directors and officers of their choosing. *Id.* at 35. However, the United States Court of Appeals for the D.C. Circuit has ruled that SEC administrative compliance proceedings do not violate the due process clause of the constitution. Binder, Rohinson & Co. v. SEC, 837 F.2d 1099, 1104-08 (D.C. Cir. 1988).

175. Broader concerns about the breadth of prosecutorial and adjudicative discretion granted to many agencies are also valid. *See* Michael R. Lanzarone, *Professional Discipline: Unfairness and Inefficiency in the Administrative Process*, 51 FORDHAM L. REV. 818, 819-22 (1983).

176. However, many bar orders are not appealed because they are reached as part of a settlement rather than a cease-and-desist order or injunction. *See supra* Part II.A.

177. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809-10 (codified at 15 U.S.C. §§ 7201-7266).

178. *See infra* Part II.

179. 15 U.S.C. §§ 78(t)(e), 78u(d) (2000).

180. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 214 (1976) (holding that scienter is necessary for a violation of Section 10(b), so that mere negligent behavior will not fall within the antifraud provision).

181. Furthermore, this is not the only law whereby a person's future employment options are limited. Disbarment and revocation of professional licenses are other examples. Another is federal banking law, which does not allow any person convicted of a criminal offense involving dishonesty or a breach of trust to "participate, directly or indirectly, in the conduct of the affairs of any insured depository institution." 12 U.S.C. § 1829(a)(1)(A) (2000).

B. Uncertain Definition of "Unfitness" Is a Disincentive for Potential Directors

The scandals of the past several years have underscored the importance of having a strong board of directors to provide oversight and accountability for officers. However, one of the unintended consequences of Sarbanes-Oxley may be to discourage some capable people from serving as directors. Representative Michael Oxley (R. Ohio), cosponsor of the Act, told a meeting of the National Association of Corporate Directors that Sarbanes-Oxley may make it difficult to recruit the requisite independent board members.[182] This is a particularly apt consideration considering both the ease with which the SEC can now issue a permanent bar and the fact that there is no definition of what constitutes unfitness. Would-be directors who do not feel confident that they can recognize unfit behavior before it is too late may decline to serve rather than risk a permanent bar.

Recent statistics support Representative Oxley's contention that directors are becoming more difficult to find. A vice chairman of executive recruiting firm Spencer Stuart said that only one out of eight director candidates that he pursues today accepts a seat, compared to one out of four just five years ago.[183] The increase in average board member salary in recent years provides further evidence that it is getting harder to find board members.[184]

The increase in board salaries, however, is probably much more closely related to directors' fear of civil liability and increased workload than to concern over an SEC suspension order.[185] It is doubtful that eliminating the SEC's suspension powers would significantly change any potential or actual director shortage. Furthermore, the drafters of Sarbanes-Oxley attempted to alleviate directors' liability concerns somewhat by removing the chairman of

182. Phyllis Plitch, *US Rep Oxley: Accounting Bill 'Struck Reasonable Balance,'* DOW JONES NEWS SERVICE, Sept. 30, 2002, WL 9/30/02 DJNS 16:45:00. The reasons that people will be reluctant or unable to serve as directors are primarily the increased fear of liability, but there can also be other reasons, such as those requiring directors to have accounting expertise. *Id.*

183. Joann S. Lublin, *Corporate Governance (A Special Report)—More Work More Pay: Directors Are Taking on Greater Responsibility These Days; And Despite Shareholder Skittishness, They're Getting Bigger Paychecks as Well,* WALL ST. J., Feb. 24, 2003, at R4.

184. A December 2002 poll of sixty companies found that two thirds of those surveyed increased directors' compensation last year or plan to do so. *Id.* On average, directors received about $152,000 in 2001. *Id.*

185. The time demanded of directors at large corporations has increased by twenty five percent over the past ten years. Moreover, directors who fail to detect fraud by managers are now more likely to face lawsuits and public criticism. Carol Hymowitz, *Corporate Governance (A Special Report)—How to Fix a Broken System: A Rush of New Plans Promise to Make Corporate Boards More Accountable. Will They Work?,* WALL ST. J., Feb. 24, 2003, at R1.

the board from the list of individuals who must certify a company's financial statements.[186] Potential board members can take comfort in the fact that, in order to be barred, they must not only be deemed "unfit" but must also be found guilty of securities fraud—a violation which is well defined in case law and requires a fairly high level of scienter.[187] The risk of repelling qualified directors is therefore not serious enough to justify limiting the SEC's suspension powers.[188]

VII. RECOMMENDATIONS

Although the SEC's increased suspension powers will fill an important gap in securities fraud prevention, there are additional actions that the SEC could take to make the suspension provisions more effective. First, the SEC should consider issuing a release explaining its position on officer and director bars. Such a release would remind corporate America that this provision exists, and put potential defrauders on notice of yet one more reason to obey securities laws.[189] This release could also provide an opportunity for the SEC to clarify what it thinks constitutes unfitness deserving of a permanent suspension. By defining unfitness, the SEC could provide additional security for honest people who serve on boards of directors but are worried about inadvertently stepping over an invisible line and having their careers cut short. This might even be an excellent opportunity for the SEC (instead of the federal courts) to set the terms of what constitutes unfitness after Sarbanes-Oxley.[190]

Several recent examples illustrate the benefits that could be gained by an SEC release defining unfitness. Rules 10b5-1 and 10b5-2, passed in 2000, define trading on the basis of insider information

186. *See President Signs Sweeping Corporate Reform Bill into Law*, DEL. CORP. LITIG. REP., Aug. 19, 2002, at 10, 11. CEOs and CFOs, on the other hand, can face as much as $5 million in fines and twenty years in prison for willful false financial statements. Michael Rosenzweig, *Corporate Responsibility Redefined: How to Prepare for the Coming Changes*, THE CORP. COUNSELLOR, Aug. 2002, at 1.

187. *See supra* note 180.

188. Phyllis Plitch, *Corporate Governance (A Special Report)—Ready and Able? Companies Say the List of Qualified Directors is Depressingly Short. Critics Say That's Because Companies Are Looking in the Wrong Places*, WALL ST. J., Feb. 24, 2003, at R3 (discussing the argument that there are plenty of qualified board members available, and that the perceived shortage is only the result of current directors' failure to look beyond their limited social and professional circles).

189. There have been relatively few permanent suspensions to date (although the number is increasing), and the SEC's increased power in this area has so far gotten little attention in the press. *See supra* notes 122-123 and accompanying text.

190. Sarbanes-Oxley's change from "substantial unfitness" to "unfitness" is not precise, but it clearly indicates that Congress is lowering the bar on when permanent suspensions can be issued. It would seem that whoever addresses the issue first—be it the courts or the SEC—has the opportunity to set the stage for defining where the bar is now.

and duties of trust or confidence for purposes of insider trading cases.[191] Regulation FD,[192] also passed in 2000, prohibits selective disclosure of information by issuers of securities and clearly defines the scope of liability under the regulation.[193] These rules provide the certainty needed to avoid costly litigation, and in the case of Rules 10b5-1 and 10b5-2, have allowed for more wealth-creating transactions.[194] Similarly, some guidance by the SEC with regard to "unfitness" could encourage capable people to serve as directors and maximize wealth in the securities markets.[195]

This Note will not attempt to recommend every factor that the SEC should include in its definition of unfitness. It would seem reasonable to include some of the factors from the *Patel II* test, such as egregiousness, scienter, and evidence of ongoing fraud, but if the Commission does so, it should clearly state that no single factor is dispositive for a permanent suspension.[196] In the past, the SEC has rightly noted that defining securities fraud too precisely could have a deleterious effect.[197] The SEC has called bright-line fraud definitions "blueprint[s] for fraud."[198] Instead, the Commission prefers to keep some ambiguity to prevent unscrupulous executives and their lawyers from creating schemes that stay within the letter of securities fraud regulations but nonetheless violate the intent and spirit of the law.[199] The SEC will therefore have the difficult task of providing enough certainty to encourage honest, qualified individuals to serve as

191. 17 C.F.R. §§ 240.10b5-1, 240.10b5-2 (2003).

192. 17 C.F.R. §§ 243.100 - 243.103 (2003).

193. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,718-20 (Aug. 24, 2000) (final rule).

194. By defining trading "on the basis of" insider information and "duties of trust or confidence," the Rules allow parties to engage in securities transactions that they might otherwise avoid due to worry that they would violate a securities law. If botb parties engaged in the trade voluntarily with full disclosure of information, then the trade transfers the security to the party that values it more highly, thereby creating wealth.

195. This guidance should not, however, be too specific, as discussed in the following paragraph.

196. *See* SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995). The SEC might also suggest that it only be required to show a "reasonable likelihood" that future violations are likely before a suspension can be issued; or perhaps even place the burden on the defendant to show that future violations are unlikely to occur.

197. *See* JAMES D. COX ET AL., SECURITIES REGULATION 14 (2001); *see also* Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 650-51, 662-64 (2002) (noting that the SEC supported using "recklessness," as opposed to a knowing state of mind, as the national fraud standard).

198. COX ET AL., *supra* note 197, at 14.

199. *Id.*

directors, while simultaneously providing enough flexibility to prosecute clever defrauders.

In addition to issuing a release on officer and director bars, the SEC must demonstrate its willingness to use its expanded bar powers. This should be done so as to demonstrate both the SEC's willingness to use its increased powers and its care to only bar egregious wrongdoers who present a real threat to securities markets.[200] The SEC's action against Martha Stewart in June of 2003 provides a good example of the sort of balance that will be needed.

Martha Stewart's high profile makes it certain that many people will take notice and become aware of the possibility of temporary and permanent suspensions by the SEC. At the same time, the SEC has attempted to demonstrate restraint by barring Martha Stewart from serving as a director but allowing her to continue to serve as an officer (albeit in a somewhat limited fashion) in her own company.[201] The restrictions sought by the SEC would allow Martha Stewart to continue contributing to the creative end of Martha Stewart Living Omnimedia to avoid causing undue damage to the company.[202]

The firm-but-measured approach that the SEC has taken with Martha Stewart will be important to retain in the future. If the enforcement is too lenient or used too infrequently, the SEC's suspension powers will continue to be ineffective as a deterrent. On the other hand, if the enforcement is too aggressive there could be a backlash against the SEC by the public and federal courts. If the SEC's use of bars against alleged securities law violators like Martha Stewart is perceived as being excessive, the Commission could lose the political momentum currently supporting its crackdown on corporate wrongdoers.[203] Moreover, if the SEC is overly aggressive in issuing

200. Direct suspensions by the SEC will now come through cease-and-desist orders rather than through injunctions. However, according to legislative history and the past practices of the SEC, cease-and-desist orders are generally to be used for less serious violations while injunctions are said to be more appropriate for serious violations. *See* Morrissey, *supra* note 45, at 465-66. Courts may be leery of this expanded role of the cease-and-desist order, but courts are not likely to overturn cease-and-desist order suspensions since they are so clearly permitted now by statute.

201. Wolverton, *supra* note 1.

202. *Id.*; *see also SEC: Curbs on Stewart Not Meant to Damage Company—NYT*, WSJ.com (June 4, 2003) (Director of the SEC's northeastern regional office told the New York Times that "the kinds of limitations we are looking at would allow her to continue in the creative end of the company, but remove her from other activities. We do not want to do anything that damages the company if it can be avoided.") (on file with author).

203. Indeed, some see the SEC's enforcement actions against Martha Stewart as being excessive, especially given the fact that the insider trading case against her does not seem entirely certain nor particularly egregious. *See* Erin McClam, *Martha's Message: 6 Million Visit*

permanent suspensions, there is a risk that federal courts might begin to strike down those bars on appeal and adopt a new standard that is only slightly less stringent than the *Patel II* test—thus only paying lip service to the change from "substantial unfitness" to "unfitness."

VIII. CONCLUSION

Recent corporate scandals have powerfully demonstrated how much destruction of wealth and damage to public confidence can result from corporate fraud. The Sarbanes-Oxley Act of 2002 provides a number of changes to help reduce fraud in the future. One of those changes is increased power for the SEC to permanently bar securities fraud violators from serving as officers or directors of publicly traded companies. Although the SEC has had this power since the Remedies Act was enacted in 1990, it has had trouble issuing suspensions because of the stringent standard for substantial unfitness adopted by the courts. Congress increased the SEC's power to issue permanent suspensions by lowering the standard from substantial unfitness to unfitness and by allowing the SEC to issue suspension orders directly in a cease-and-desist proceeding without going through the federal courts.

Permanent officer and director suspensions are frequently unnecessary due to a number of other factors that reduce corporate fraud. However, while market forces and criminal and civil penalties may serve to deter corporate fraud in most cases, there are times when all of these factors fail. In those situations, a permanent bar may be the best way to protect the investing public and the integrity of the United States markets.

Several concerns need to be considered in the context of permanent bars, including the due process rights of defendants and shareholders and the possible negative effects on the pool of capable and willing directors. However, there are a number of safeguards that protect the defendant facing permanent suspension, and the impact of suspension law on potential directors is probably quite low. Still, it may be beneficial for the SEC to issue a release that explains some of its criteria for issuing suspensions, provided that the release contains

Her Defense Web Site, ASSOCIATED PRESS NEWSWIRES, June 9, 2002, WL 6/9/03 APWIRES 19:42:00 ("Fans have suggested Stewart is being charged because she is a celebrity and that her case pales in comparison to other corporate fraud."); *see also* James Toedtman, *Securities Law Tested; One Year Later, Measure Shows Mixed Results*, NEWSDAY (New York), July 27, 2003, at A43 ("[S]o far, showcase executives Ken Lay and Jeffrey Skilling of Enron, Bernard Ebbers of WorldCom, Dennis Kozlowski of Tyco, Scrushy and others whose high salaries and lavish lifestyles were examples of what Federal Reserve Board Chairman Alan Greenspan called 'an era of infectious greed' remain unpunished.").

a good balance of security for well-meaning executives and flexibility for future enforcement purposes. It will also be important to prosecute securities fraud violators such as Martha Stewart in a way that demonstrates the Commission's willingness to use its suspension powers and its moderation in only pursuing defendants with a high degree of scienter and culpability. It may prove difficult for the SEC to strike this balance, but if it succeeds in doing so, the officer and director bar provisions may become a much more important force in the future for protecting the integrity of U.S. markets.

*Philip F.S. Berg**

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