ABSTRACT

Federal Fiduciary Duties for Directors

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This paper considers the role of independent directors as securities monitors. Rather than engaging in the debate about whether independent directors are good or bad, important or unimportant, the paper takes their existence and basic governance role as a given, focusing on their role as detailed in the federal securities laws, regulations, and releases. To the extent that directors are supposed to play a monitoring role in the corporation, exercising both guidance and a check and balance, the securities laws are part of the mechanism to ensure that they fulfill that role.

From the SEC’s perspective, independent directors are on the board for a reason. Their role is to act as securities law monitors. Although this role is particularly serious when it involves statements the directors draft or sign, it also includes an ongoing responsibility to be informed of developments within the company, to ensure good processes for accurate disclosures, and to determine if disclosures are adequate. Independent directors with expertise should be involved in reviewing and, sometimes, drafting statements. All directors, however, should be fully aware of company statements and sufficiently engaged and active to question and correct inadequate disclosures. This role of securities monitor is yet another way of implementing the information-forcing-substance disclosure model that the SEC has always utilized to achieve corporate governance. In addition to defining and animating the role of independent directors as securities monitors, I review the ways in which private causes of action and the SEC’s enforcement powers are available to ensure that directors have the proper incentives to fulfill their securities monitoring role and provide a discussion of some circumstances in which it seems likely the SEC might focus its spotlight on independent directors.

Key words: directors, corporate governance, liability, securities law, corporate law
Federal Fiduciary Duties for Directors

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Serving as a . . . director of a public company is a privilege which carries with it substantial obligations. If a[] director knows or should know that his or her company’s statement concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure. An officer or director may rely upon the company’s procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues.¹

Introduction.

Much has been written about independent directors and their role in the corporate governance structure. The focus, however, has largely been on state law and the role of independence in the boardroom and in determining liability. With the exception of self-regulatory organization rules, less attention has been paid to the federal side of the equation. This article aims to rectify that neglect by focusing on the Securities and Exchange Commission’s (SEC) recently professed intent to heighten its scrutiny of the role of independent directors in the corporation and the boardroom.

I refer to this role as the securities monitoring role and, for the purposes of this article, focus on it only in the context of independent directors. The article does not engage in the debate about whether independent directors are good or bad, important or unimportant.² Instead,

² Nor does this paper enter into the debate about director primacy, though arguably, by extending the theory about the role of board members as securities monitors, it supports it. See, e.g., Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83 (2004); Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547 (2003); Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 STAN. L. REV. 791 (2002); Lynn A. Stout, The Shareholder As Ulysses: Some Empirical Evidence on Why Investors In Public Corporations Tolerate Board Governance, 152 U. PA. L. REV. 667, 671 (providing empirical evidence that shareholders may prefer the director primacy model); but See Larry E. Ribstein, Why Corporations?, 1 BERKELEY BUS. L.J. 183, 196 (2004) (arguing that the director primacy model of the firm is “too rigid to achieve the right balance between discretion and accountability for many firms”). See also Ethan G. Stone.
the article takes their existence and basic governance role as a given. The goal here is to define the role of independent directors in the context of securities laws and regulations. To date, the securities monitoring role of independent directors has been undefined. This article, however, reveals an existing infrastructure supporting the role and provides some definitions for it. It does so, first, by situating it within the general corporate governance framework of securities law and corporate fiduciary duties. Then the article explores how the securities laws and regulations as currently conceived, both statutorily and by the courts, work to ensure that independent directors perform the prescribed securities monitoring and governance functions. And, it examines the SEC’s more specific statements about the role of independent directors.

The article also provides a brief review of the SEC’s enforcement powers and its remedial tools. Unlike private litigants, the SEC has a very flexible set of tools at its disposal, which, if deployed against independent directors, can provide specific and powerful incentives. To date, the SEC has used only reputational sanctions against independent directors, but actual liability and equitable sanctions are both available and more accessible than the rare private-litigation sanctions against outside directors. I conclude by providing situations in which the SEC is most likely to proceed against independent directors and focusing on the ways in which the securities monitoring role is likely to grow.

Federal Securities Law and Corporate Governance – An Overview.

To begin with, the role of independent directors as securities monitors is but one part of the general overlay of federal securities law in corporate governance. A review of that law and its history, however, helps to ground the independent director role. Moreover, given the SEC’s recent statements that it intends to begin reviewing the actions of independent directors for potential enforcement actions, a deeper understanding of how independent directors’ securities monitoring role fits into the general corporate governance framework of securities law is useful.

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*Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies with the Board’s Distinct Fiduciary Roles, ___ J. Corp. L. ___ (2006).*

3 The SEC, the courts, the legislative bodies, and the self-regulatory organizations (the SROs) have all done so and considerable law is predicated on that role. Cf. Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERK. BUS. L. J. 315 (arguing that current independence definitions in regulations and common law do not go far enough and that better measures of “autonomy” are necessary to achieve independent acting directors).

4 See Memorandum, *Supreme Court Clarifies Requirement for Pleading and Establishing “Loss Causation” in Securities Fraud Lawsuits*, Fried, Frank, Harris, Shriver & Jacobson, L.L.P., 1501 PLI/Corp 721, 730 (Westlaw) (acknowledging that sanctioning of independent directors is rare in private litigation).
Federal securities laws and regulations occupy a significant position in the more general world of corporate governance. Although state law operates largely in a default manner to provide directors with broad powers to direct and manage corporations, federal securities law intervenes in the governance structure – perhaps more directly today than ever before. The traditional view of securities laws and regulations is that they are about disclosure and not substantive governance. The theory behind the regulatory structure was that if forced to disclose information about particular transactions or programs, the issuer and its officers and directors would be more likely to engage in thoughtful processes and achieve good substantive outcomes. The same is true today – federal securities laws and regulations are disclosure-based, but the effect of the disclosure requirements is deeper and than just what issuers say and when they say it. And, as this article reveals, the potential impact on independent directors may well be quite powerful.

In brief, the indirect, disclosure focus of the federal system was the result of a compromise. President Roosevelt called for the federalization of corporate law at the turn of the century and his calls were reiterated by two successive presidents, but Congress declined to adopt any such legislation. It was not until the 1930s, in response in part to the Great Depression, that Congress acted. When it did so, it adopted the Securities Act of 1933 and the Securities Exchange Act of 1934 (together, the “Acts”). This legislation stopped short of federalizing corporate law, focusing on the integrity of the markets through the production of complete and accurate information. The result was the beginning of a significant area of law and regulation for publicly held companies, or issuers.

Although the federal government chose not to create a direct form of corporate law, the Securities and Exchange Commission now has authority over an extremely elaborate set of indirect regulations. Thus, the Acts require extensive disclosures in the capital raising context as well as on a quarterly and annual basis. The required disclosures are designed to diminish informational asymmetries between issuer insiders and those purchasing its securities. However, the Acts also utilize disclosures to create incentives for specific corporate action. The SEC does this by, for example, regulating the content of disclosures in detail. Issuers are required to provide disclosures about various corporate systems or plans. If they do not have the system or plan in place before the disclosure is required, they must inform the market that they have chosen not to have the program. Alternatively, they can create the program, plan, or system. By requiring disclosure of choices not to provide systems or plans, then, the requirement

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6 Id.
7 Id.
serves as an incentive for issuers to create the system or plan. Thus, the
demand for information creates the demand for the system or plan. The
result is actually substantive change. The disclosure requirement indirectly
regulates substance and acts as substantive corporate law.

Overtime, the SEC has expanded the number and extent of the
required disclosures so significantly that they occupy hundreds of pages of
the federal register. The information-forcing-substance nature of these
requirements maps onto corporate fiduciary duties in many ways. Some of
the requirements push in the direction of care and good faith. Others are
loyalty focused. Many can be enforced by private plaintiffs. Some can be
enforced by private plaintiffs and by the SEC. Others are can be enforced
only by the SEC. All have an impact on the tasks of independent directors.

The most recent requirements are forthright in settling into the state-
law, corporate-governance space. Post-Enron, for example, CEOs and
CFOs must certify securities filings, stating that the filings are correct and
complete. Before they can do so, however, they must discuss and review
certain reports with the audit committee of the board of directors. The
failure to do so, or to do so properly, is subject to both civil and criminal
measures. This provision of federal statutes and regulations, then, is a
direct intrusion into what is still referred to as the states’ corporate law
domain. The discussion and review requirement implicates the
independent directors who sit on the audit committee. As this article will
reveal, they are potential liable if they simply rubber-stamp the statements
or information provided to them by the officers. Moreover, the so-called
intrusion into corporate governance and the functions of independent
directors is not new. The statutes in some very explicit ways, and the SEC
in very direct statements, have tasked directors with the job of being
securities law monitors.

The Securities Monitoring Role.

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8 See id. at 873-74 (describing regulatory requirement that annual report provide specific
information about trends that might increase or decrease issuer liquidity along with a
description of the issuer’s plan for addressing any deficiencies). See also 17 C.F.R. §
229.303(a) (2005).
9 See id.
10 See id. at 873-875.
11 See id. at 873-875.
12 This statutory change was originally implemented by the SEC, pursuant to section
13 See Sarbanes-Oxley Act § 302 (a)(5).
15 See, e.g., Wells M. Engledow, Handicapping the Corporate Law Race, 28 J. CORP. L.
143 (2003) (discussing the drawbacks of excessive federal regulation of corporate and
securities law).
To begin with, it is useful to have a definition of the term “independent director.” For the purposes of this paper, I define the term in the same way that the New York Stock Exchange does.\textsuperscript{16} The Delaware common law definition of an independent director is more nuanced than the NYSE rules.\textsuperscript{17} The SEC, however, approved the NYSE definitions of independence, making it more likely that the SEC would determine which directors are independent from the NYSE’s more formulaic definition. The focus of this paper, of course, is not on which directors are independent, but what their responsibilities are in monitoring their companies’ securities processes and disclosures. This section of the article provides the boundaries for and definition of that role.

The place of independent directors in corporate governance has received considerable attention in recent years.\textsuperscript{18} To the extent that

\textsuperscript{16} Under NYSE rules, a majority of the members of any listed company’s board must be independent. \textit{NYSE Listed Company Manual}, § 303A.00., available at: http://www.nyse.com/frameset.html?displayPage=/listed/102221393251.html. To qualify as independent, the directors must not have any significant familial or financial ties with the company. \textit{Id.}, Commentary to § 303A.02. There are a few other specific twists, including a prohibition on interlocking directorships. § 303A.02(b)(iv). The NYSE recently proposed a change to these rules that would require listed companies to “disclose affirmative reasons for its findings that its independent directors are, in fact, ‘independent.’” \textit{See Stock Exchanges: NYSE Seeks Rule Change on Director Independence, BNA’s Corporate Governance Report, Westlaw, 9 BNA CGR 01 d11 (Jan. 2, 2006).} These proposals, do not, however, change the substance of the NYSE rules. They focus only on providing better disclosure to shareholders on proxy statements. For a criticism of these rules and their simplistic nature, Stephen M. Bainbridge, A Critique of the NYSE’s Director Independence Listing Standards, 30 Sec. Reg. L. J. 370 (2002) (arguing that the NYSE’s “one size fits all approach” to director independence is “seriously flawed”); \textit{see also} Paul G. Mahoney, \textit{Exchange as Regulator}, 83 VA. L. REV. 1453 (1997) (discussing the political nature of exchange-based regulation more generally).

\textsuperscript{17} Delaware divides director “conflicts” into two categories. The first is independence. To be independent of the officers and other directors, a director must not be beholden to her fellow board members and able to formulate her own decisions on issues free of improper influence. \textit{See, e.g., In re the Limited, Inc., Shareholders Litig., 2002 WL 537692 (Del. Ch. 2002)} (reviewing individual directors under interest and independence standards). For a recent discussion of the evolution of Delaware case law in this area, \textit{see E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments, 153 U. PA. L. REV. 1399 (2005).}

directors are supposed to play a monitoring role in the corporation, exercising both guidance and a check and balance, the securities laws are part of the mechanism to ensure that they fulfill their role. When a company makes disclosures, it must ensure their accuracy. According to the SEC, directors with expertise should be involved in reviewing and, sometimes, drafting some statements. But all directors should be fully aware of company statements and sufficiently engaged and active to question and correct inadequate disclosures. This role of securities monitor is yet another way of implementing the information-forcing-substance disclosure model.

Arguably, the earliest provisions that help to define the role of directors as securities monitors grow out of the 1933 Securities Act and the due-diligence defense. The due-diligence defense can relieve directors from an otherwise strict-liability cause of action for misstatements and omissions of material facts in an issuer’s registration statement. A review of that provision and the cases and SEC interpretations then, provides a foundation for the definition of role of directors as securities monitors. Under section 11 of the 1933 Securities Act, all those who sign the registration statement\(^{19}\) and all directors of the issuer in office at the time of filing,\(^{20}\) as well as directors named, with their consent, as about to become directors are strictly against a supermajority of independent directors and advocating further empirical studies on the effects of the Sarbanes-Oxley corporate governance changes); Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 497 (2004) (arguing that “director independence brings accountability and responsibility” to corporations and is “a critical component of modern governance theory”); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797, 800 (2001) (suggesting that boards with a greater number of independent directors may lack trust, chilling communication and weakening the monitoring ability of the board; defining an independent director as “one who actually takes the monitoring task for the benefit of the shareholders and/or other constituencies seriously”); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) (using empirical data to show that a greater proportion of independent directors does not improve profitability); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDozo L. REV. 265, 267 (1997) (suggesting that a greater number of independent directors places too much emphasis on the monitoring role of boards at the expense of the management role); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 27 (2002) (noting that while independent directors do not increase profitability, they may be better at “supervising their firms' financial disclosures and relationships with auditors”); Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 93 (1997) (advocating a duel board system where one board, made up of independent directors, deals with conflicts monitoring, while another board, consisting of inside and independent directors, takes on the managerial roles).

\(^{19}\) 15 U.S.C. § 77k(a)(1).

liable.\textsuperscript{21} Thus, “no matter how new he is” section 11 can, at least nominally, be used to impose liability on a director.\textsuperscript{22}

The statute’s purpose is to deter fraud in offering documents, and the provisions attaching liability to directors are designed to ensure that they take an active role in cleansing the registration statement. Thus, section 11 lays the groundwork for the role of independent directors as securities monitors. However, unlike the issuer, which faces strict liability for “even innocent misstatements” or omissions,\textsuperscript{23} directors have a due-diligence defense.\textsuperscript{24} The defense converts an otherwise strict-liability cause of action into a negligence-like cause of action. Although only private litigants can pursue directors and others for liability under section 11, its role and the due-diligence case law is important to an understanding of the SEC’s approach to the securities monitoring role of independent directors.

The purpose of the due-diligence requirement is to support the goal of the statute, accurate disclosures, by placing responsibility on directors (and others) for reviewing background materials and asking questions before agreeing to sign or be named in the registration statement.\textsuperscript{25} The defense is complete, and, therefore, potentially quite powerful. If a director defendant successfully proves that she did a reasonable investigation and had reasonable grounds to believe, and in fact did believe, that the registration statement did not contain misstatements or omissions at the time it became effective, she will not be liable.\textsuperscript{26} Thus, directors who are active and engaged, who are question askers, and who vet before signing, will not be liable.

Directors do not have to screen every statement or assertion on their own. In the course of their due diligence, independent directors properly rely on officers and experts, and that reliance is properly part of their defense. When it comes to relying on company officers, however, directors

\textsuperscript{21} 15 U.S.C. § 77k(a)(3).
\textsuperscript{22} Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 688 (S.D.N.Y. 1968) (finding liable new director, with “little opportunity to familiarize himself” with issuer’s affairs). In addition, directors who resigned or took steps to resign from their post with the issuer prior to the registration statement’s effective date and who notified the SEC and the issuer disclaiming any liability, are protected. 15 U.S.C. § 77k(b)(1) (2005).
\textsuperscript{23} Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).
\textsuperscript{24} 15 U.S.C. § 77k(b).
\textsuperscript{25} See Hillary A. Sale, Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act, 75 WASH. L. REV. 429, 435 (2002).
are not to be blind or exclusive in their reliance. Instead, they need to test “oral information by examining the original written records.”

They can also rely on expert opinions if they had “no reasonable ground to believe and did not believe,” as of the effective date, that the registration statement contained any untrue statements or omissions, also have a good argument. For example, if an accountant has completed certified financial audits, directors may rely on those. Their reliance is limited, however, to situations in which they are able to prove they knew the statements were audited, believed the statements to be correct, had no reason to believe otherwise, and there were no so-called red flags about which they should have known. The existence of these defense arguments means that independent directors are less likely to be found liable under section 11 than their insider counterparts.

In addition, the SEC set forth some guidelines on section 11 liability and the due-diligence defense for defendants, including, independent directors, in Rule 176. Until the recent Worldcom litigation, courts had not been "called upon to interpret Rule 176." It offers some helpful guidelines, arguably a baseline, for what defendants must do before accessing the due diligence defense. For example, Rule 176 provides

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28 Id. at 692.
30 See Worldcom, 346 F. Supp. at 666; Escott, 283 F. Supp at 643 (finding that independent director succeeded with due diligence defense when he proved he knew financial statements were audited by auditor in whom he had confidence). See also John Nuveen & Co. v. Sanders, 450 U.S. 1005 (1981) (noting that non-issuer defendants can rely on accountant reports in the context of a 12(a)(2) claim).
31 Worldcom, 2005 WL 638268 at *8.
32 See Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 578 (E.D.N.Y. 1971) (noting that insider directors have “intimate knowledge” about issuers and correspondingly more stringent duty of inquiry resulting in liability for “practically all cases of misrepresentation”); See also Goldstein v. Alodex Corp., 409 F. Supp. 1201, 1203 (E.D. Pa. 1976) (holding that outside directors were entitled to indemnity from defendant corporation against plaintiff’s claims since outside directors acted in good faith in signing the registration statement, and since inside directors are more responsible for having an “intimate” knowledge of facts in a registration statement).
35 See In re Worldcom, Inc., Sec. Litig., 346 F. Supp at 677-79 (noting that although Rule 176 provides for some flexibility in the interpretation of the due diligence defense, the few
several factors that may be used in assessing the availability of a due-diligence defense, including the type of issuer; the type of security; the type of person; the relationship of the person to the issuer, including whether the person is a director or proposed director; the reasonableness of that person’s reliance on employees and others in positions to provide knowledge about the facts; and whether the person had particular responsibility for a fact or document incorporated by reference. Although a desire for less liability on the part of underwriters was part of the impetus for the adoption of Rule 176, the SEC held firm to its view that due diligence is required. Specifically, the Commission specifically noted that appropriate time should be allocated to its completion, along with “its attendant vigilance and verification.”

Notably, in the context of this article, in the release accompanying Rule 176, the SEC addressed the particular due-diligence role of directors. Thus, according to the SEC, independent directors must be active in their due diligence, but the burden, so to speak, varies with office and experience. For example, the SEC stated that directors may be in a unique position to evaluate disclosures and to ensure whether further due diligence is necessary, because they receive and review company information and filings and “plan and participate in the company’s business.” It also provided illustrations of the factors and circumstances relevant to section 11 liability, noting that due-diligence requirements properly vary with the director’s roles. “Independent directors with no special knowledge or additional responsibility” are entitled to a lower standard of investigation than their inside or expert peers. They are entitled to reasonable reliance on employees, including, presumably, officers, if those employees had duties that should have provided reasonable knowledge of the facts in question. Importantly, the purpose of these provisions and the general list of cases that exist insist on actual and active investigation by underwriters before they can successfully invoke defense).

36 Id.
37 Worldcom, 2005 WL 638268 at *8.
38 Id. at *11.
39 Id. at *12.
40 Id. at *12. See also, In re Worldcom, Sec. Litig., 346 F. Supp. 2d at 677 (noting access to information as important for directors).
41 Id. See also 17 C.F.R. § 230.176(e) (2005).
of factors was to cabin liability for independent directors.\textsuperscript{44} Thus, although with this release, the SEC made clear that its view that independent directors may not escape their responsibilities and the potential liability that goes with them, but, in certain circumstances, the liability can be diminished.

In practice, the standards for the due diligence defense for directors have not been litigated often. The recent Worldcom case is quite illuminating. The plaintiffs had alleged a “secretive scheme” by Worldcom executives to misrepresent the company’s financial condition, asserting that two “enormous” bond offering documents contained section 11 violations.\textsuperscript{45} In the summary judgment context, one of the independent directors, Bert C. Roberts, Jr., argued that he reasonably relied on Worldcom officers and auditors in connection with the company’s registration statement.\textsuperscript{46} To explore whether Roberts could succeed with a motion for summary judgment based on his due diligence defenses, the district court considered the standard applicable to such defenses: “whether the person’s conduct constitutes a reasonable investigation or a reasonable ground for belief.”\textsuperscript{47}

At summary judgment, the court rejected Roberts’s due-diligence defense. In its analysis, the court first noted that as an independent director, Roberts may have had lesser obligations than his inside-director counterparts, but he could not blindly rely on the financial information provided by the audit committee and Worldcom’s senior management.\textsuperscript{48} Although the court specifically noted that reliance on audited financial statements can defeat section 11 liability, it also pointed out that a jury might find that the red flags in Worldcom’s finances should have put even an independent director on notice that further due diligence was required. In reaching this conclusion, the court focused on Roberts’s particular expertise in the telecommunications industry.\textsuperscript{49} Moreover, the court stated that Roberts had failed to show that he had “conducted any sort of investigation, much less a reasonable investigation in light of all relevant circumstances.”\textsuperscript{50} The opinion thus lays down a clear line -- independent directors must be active, good faith securities monitors before they will succeed in avoiding liability.

The independent directors eventually settled this case.\textsuperscript{51} On March 18, 2005, the parties executed a settlement agreement that covered all

\textsuperscript{46} Id. at *3.
\textsuperscript{47} Id. at *5.
\textsuperscript{48} See id. at *11.
\textsuperscript{49} Id.
\textsuperscript{50} Id. at *12.
\textsuperscript{51} In re WorldCom, Inc. Securities Litigation, 2005 WL 2293190 (S.D.N.Y. 2005).
twelve of the directors.\footnote{Id.} There was an earlier director settlement in this matter, which two of the directors did not join.\footnote{Id.} Both, however, joined the later settlement, agreeing to make substantial personal contributions ($4.5 million for Roberts) to a total fund to settle the case.\footnote{Id.} Other directors contributed approximately 20% of their personal net worth to settle the claims, resulting in a total individual contribution of $24.75 million toward a settlement for all of the directors of $60.75 million.\footnote{Id.} The difference of $36 million was contributed by Worldcom’s excess insurers.\footnote{Id.}

Given that this case provides one of a very small set of cases in which independent directors have faced actual personal liability, it is very telling in its power.\footnote{Id.} The court’s effort to define the due-diligence defense also provides some contour for the nature of the independent directors’ securities monitoring role. The court makes clear that active and involved directors are necessary and important to vetting securities disclosures. SEC releases add substantially to an understanding of this role.

**SEC Releases.** The SEC’s statements on this role and its prior enforcement actions, when read together, very carefully delineate a role for independent directors as “securities monitors,” tasking them with reviewing and managing company disclosures to ensure accuracy, updates, and corrections.\footnote{See Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Independent Directors of National Telephone Co., Inc., Exchange Act Release No. 14380 (Jan. 16, 1978) (hereinafter “National Telephone Release”).} For example, the SEC has stated that directors who are not “reasonably well informed . . . [do] not provide the shareholders with any significant protection in fact.”\footnote{See Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation, Exchange Act Release No. 11516 (July 2, 1975), (hereinafter “Stirling Homex Release”).} Specifically, the SEC has rebuked independent directors whose “presence on the board [did not] have the impact upon the company’s operations which shareholders and others might reasonably have expected.”\footnote{Id.}

Further, from the SEC’s perspective, independent directors are on the board for a reason. They ought to play a “significant role in the
direction of a company’s affairs,” particularly when they have relevant expertise, experience, and sophistication. 61 Their role is to act as securities law monitors and ensure that publicly-held companies comply with their securities duties. The securities monitor role is particularly serious when it involves statements the directors draft or sign, but it also requires directors to accept the “responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made.” 62 Managers prefer not to disclose bad news to the public. 63 Yet, under the securities laws, the disclosure obligation of such information is often absolute. Independent directors are the ones then in the position to provide a check on management’s desire to avoid or prolong sharing bad information with investors. They are tasked with the job of acting as securities monitors. The SEC has made several statements about the role and its intent to enforce the obligation, but has not yet done much to enforce it.

The independent directors’ securities monitor role also extends beyond reliance on the company’s established procedures. If they need to bypass officers to access information, their role as securities monitors requires them to do so. 64 They should question employees or legal counsel as to the background on issues or need for disclosure of specific information. 65 If they are aware of specific non-disclosures, they must inquire into the situation. 66 Thus, as described by the SEC, the securities monitoring role arguably overlaps with the corporate governance and fiduciary roles that independent directors are supposed to fulfill. 67

61 Id.
62 See National Telephone Release, supra Note 59. See also Stirling Homex Release, supra Note 59 (commenting on independent directors in context of public offering).
64 More directors are taking their jobs seriously and spending their time inside the operations of their companies. See Directors Ditch Boardrooms for Company Trenches, AGENDA 1, 10 (Jan 16, 2006) (describing how directors at several companies are gaining greater insight into company operations by spending time with management and in facilities).
65 W.R. Grace Release, supra Note 1, at *6. See also, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the Investigation of Gould Inc., Exchange Act Release No. 13612, 1977 SEC LEXIS 1548, *6 (June 9, 1977) (stating that when management is conflicted, board must “Seek information from independent, non-interested sources” and ensure that the transaction is both fair to the company and fully disclosed to shareholders under federal securities laws).
66 See id. at *18.
More specifically, directors who “review, approve, or sign their company’s proxy statements or periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise.” As securities monitors, independent “directors must be vigilant in exercising their authority throughout the disclosure process.” As a result, independent directors who are fulfilling their corporate fiduciary duties are likely also to be appropriately active securities monitors.

Viewed in this light, the information-forcing-substance rules of the SEC take on even more power. If disclosure is required or made, it must be complete and accurate. Directors, particularly independent directors, are charged with following disclosures of all types. Sometimes, they are specifically tasked with the review of potential disclosures. Always, as securities monitors, they must ensure disclosure accuracy.

What becomes apparent from the SEC’s statements on independent directors is that, to meet their obligations, independent directors must be actively engaged in the disclosure process. They cannot, for example, be securities monitors solely by listening to officers. Active directors ask questions. Questions that do not produce answers call for more questions. If uncertainty persists, independent counsel should be engaged. Required disclosures must be vetted. SEC releases and the statutory liability provisions make clear that the failure to proceed actively is a securities monitoring failure.

An early SEC Exchange Act Release provides specifics and allows for a more robust definition of the role of independent directors as securities monitors. When the SEC investigated the National Telephone Co., Inc., it noted and faulted the independent directors and their failure to ensure accurate and current disclosures to investors. The Commission issued a 21(a) report, pursuant to the Exchange Act, focusing on the actions of the independent directors. Although the independent directors consented to the issuance of the report, they did not admit or deny the Commission’s findings.

In this report, the Commission weaves the facts of the case into a description of the securities monitoring role of independent directors. During the time of the fraud at issue, National had seven directors, only one

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68 W.R. Grace Release, supra Note 1, at * 6
69 Id.
70 See National Telephone Release, supra Note 58. The SEC’s Carter & Johnson case, involving the lawyers to the company, arose out of the same fact pattern. See Carter & Johnson, 47 SEC 471 (1981).
71 Id. SEC Docket 1393.
of which was an insider. 72 According to the Commission, the company designed, installed, leased, and maintained telephone equipment systems for commercial customers. 73 An influx of independent financing was necessary for National’s operations. 74 However, during the time prior to the problematic disclosures, National was running out of cash. 75 Its strapped financial status resulted in cutbacks, slowdowns, and business changes important to its operations. 76 The result was a clash between National’s public descriptions of its business and its financial disclosures and the reality. 77 For example, without significant infusions of cash, National could not meet the projections in its Annual Report, but it did not say so. 78 Then, three months after issuing the report, the banks with which National had a credit arrangement cut the company off. 79 National did not tell the shareholders. 80

Without the financing, National could not meet its projections. 81 It did not, however, update the projections. Instead, company management, in consultation with the entire board of directors, began to curtail operations while awaiting further financing. 82 To their credit, the directors did question the company’s plans during that time. 83 They also received copies of the press releases and shareholder letters, but did not play a role in approving them. 84 Moreover, they did not intervene when the company issued those documents, even though the statements discussed interim results without providing “any hint of National’s worsening situation.” 85

Over the next few months, National negotiated further credit and disclosed that information to shareholders, but did not disclose key terms of the arrangement that provided the lenders a security interest in all of the company’s current and future leases unless the company was able to achieve new financing. 86 Again, according to the Commission, the directors were not involved in drafting the press release or letter, but did see it. 87

72 Id.
73 Id. at 1394.
74 Id.
75 Id.
76 SHORT CITE AGAIN-NOT SURE WHAT “SEC DOCKET 1393” is-docket or p.#??, also it looks to me like “Ids” are referencing national telephone release anyway??
77 Id.
78 Id.
79 Id.
80 Id.
81 SHORT CITE AGAIN.
82 Id.
83 Id.
84 Id.
85 Id.
86 SHORT CITE AGAIN. at 1395.
87 Id.
Their failure to correct the statements, by insisting on more complete disclosures, raised the Commission’s ire.

The Commission further noted that the months following these statements were a time of increasing financial pressure.\(^{88}\) Yet, the Board neglected to meet or insist on corrective disclosures.\(^{89}\) Instead, despite the president’s failure to respond to their requests for information, the directors “did nothing to determine the status of the company’s incipient obligation . . . to cease entering new leases or the company’s consequent disclosure responsibilities.”\(^{90}\) They also ignored independent reports on the company’s financial status.\(^{91}\) The audit committee, which was composed of three independent directors, did not meet.\(^{92}\) None of the directors asked to meet with independent counsel.\(^{93}\)

As a result, according to the Commission, the directors did not learn that company management had failed to comply with the terms of the credit agreements.\(^{94}\) Although when that occurred, they acted quickly and forced the president to resign, their actions were too late to protect the company’s shareholders. They also issued a press release reporting on the financial problems and their actions, but that was the first notice to shareholders of the seriousness of National’s financial condition.\(^{95}\) In fact, the company eventually filed for bankruptcy.\(^{96}\)

What is striking about the National 21(a) report is the nature of the directors’ actions and the seriousness with which the Commission discussed them. Note that throughout the process described above, the directors did not make any public statements nor did they participate in drafting any of the statements. They were not, therefore, typical speakers. Instead, the Commission criticized the directors for failing to monitor the company’s financial condition and public statements – failing to fulfill their role as securities monitors.

In reaching its conclusion that the independent directors failed as securities monitors, the Commission offered the following description of the independent directors knowledge and fault:

… the independent directors knew about National’s need for independent capital, its cash squeeze in the fall of 1974, its
acceptance of severe restrictions on its operations in the Credit Agreement closed in December 1974, and its obligation to cease making new leases if new financing could not be obtained within the immediate future. They also knew of the highly optimistic nature of the company’s public communications.97

The Commission was not impressed by the independent directors’ argument that they had relied on the management to make the appropriate disclosures and on independent counsel to advise them as to when new disclosures were required.98 Instead, the Commission specifically tasked the independent directors with securities monitoring tasks.

According to the Commission, independent directors cannot be passive. They are “expected to maintain a general familiarity with their company’s communications with the public.”99 They must “compare such communications with what they know to be the facts.”100 When they discover that the facts and the communications do not match up, they are tasked, “as stewards for the company, [with ensuring] that appropriate revisions or additions be made.”101

Moreover, as here, when important events central to the survival of the company [are] involved, directors have a responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made. This is particularly so since there may be a tendency for corporate disclosure to lag behind developments, or, as here, there may be resistance on the part of management to make full and fair disclosure.102

It is important to note that the Commission did not limit its concern to urgent or last-period situations.103 Instead, it made a more generalized proclamation that directors need to develop “adequate, regularized procedures . . . to ensure that proper disclosures are being made.”104 It urged that the board must have a “meaningful” role in the disclosure process and

97 Id.
98 Id. at 1396.
99 Id.
100 Id.
101 Id.
102 Id.
104 SEC Docket 1393, 1396.
could achieve that goal by tasking the audit committee with the authority to manage disclosure matters.\(^{105}\)

These statements are consistent with the SEC’s Rule 176 description of the role of independent directors in monitoring offering documents.\(^{106}\) The SEC’s position in the release accompanying the proposed rule was quite firm: those wishing to invoke the cloak of due diligence had to allocate appropriate time to its completion, be vigilant, and verify.\(^{107}\) The SEC specifically tasked directors with evaluating disclosures and ensuring whether further due diligence is necessary, noting that they are well-situated to do so because they receive and review company information and filings and “plan and participate in the company’s business.”\(^{108}\) Although that release asserted a sliding-scale of due diligence such that expert and inside directors would have greater responsibilities than their non-expert or independent counterparts, the SEC was unbending in its view that all directors must exercise due diligence to invoke the defense.\(^{109}\)

The message from these SEC documents and releases is clear. Independent directors are not to engage in either blind or exclusive reliance on company officers.\(^{110}\) They are required to test information that comes from officers against with an examination of the original written records.\(^{111}\) This provision is presumably designed to prevent directors from being easily fooled with a presentation at a board meeting that does not match up with company sales records or other documents.

These obligations are particularly serious in the offering context. They were created to ensure the integrity of the markets and protect the investing public when the issuer is going to the market to raise capital. Offerings, particularly initial public offerings, are akin to insider trading.\(^{112}\) When the issuer is selling securities to the public, it is likely to be in possession of company information that purchasers do not have. The

\(^{105}\) Id.


\(^{107}\) Release 6335, Supra Note Error! Bookmark not defined., at *11.

\(^{108}\) Id. at *12.


\(^{110}\) Escott, 283 F. Supp. at 688 (finding two independent directors liable for failure to conduct due diligence and overreliance on officers).

\(^{111}\) Id. at 692.

\(^{112}\) See Hillary A. Sale, Heightened Pleading, supra note ___ at 590-91 (discussing informational asymmetry and insider trading concerns in context of public offerings).
disclosure requirements and the monitoring role of independent directors are designed to diminish the information asymmetry that exists. The SEC has the mechanisms to deploy for strict enforcement of offering duties and it makes sense for it to scrutinize misstatements and omissions in this context with greater care. As the National Telephone release makes clear, however, the SEC views the obligations of independent directors as extending beyond the offering context into disclosures more generally. Given the SEC’s recent statements that it intends to scrutinize independent directors with more care, it is valuable to understand how it views their role and the incredible flexibility of its enforcement mechanisms.

The SEC’s Role.

The SEC is the key enforcer of the securities monitoring obligations of independent directors. Although a complete recitation of the private causes of action and all of their intricacies is beyond the scope of this article, a quick review its limitations with respect to independent directors is useful to an understanding of the importance of the SEC’s role. To begin with, corporate directors, like other members of the corporate hierarchy face potential securities liability when they make misstatements or omissions. Generally, liability is tied to speaker status – either as the actual speaker or quoted person or as someone actively involved in the drafting of the document containing the misstatement or omission. Unlike the chief executive officer (CEO) or chief financial officer (CFO), directors generally, and independent directors in particular, are not often the corporate representatives speaking to the public at a press conference or in a company document. As a result, they are less likely to be sued successfully than their inside director counterparts.

Of course, independent directors do speak to the public when they sign company documents attesting to the truth of the statements. For example independent directors are required to sign the issuer’s annual report, the 10K. Without the signatures, the document cannot be filed. Directors are also required to sign public offering documents. In theory, at least, those who sign the documents ought to be subject to liability. In fact, nominal liability is explicitly provided for with public offering documents, though rarely, in fact, applied. Liability for misstatements or omissions in an annual report, however, is much less likely. The reasons for that have their origins in the statutes and in judge-made doctrines.

Section 10(b). Consider the types of potential nominal liability and how they apply to independent directors. The most prominent cause of action is the one arising out of section 10(b) of the Securities Exchange Act of 1934 and its counterpart, rule 10b-5 (“section 10 claims”). Section 10 claims are included in the Enron, Worldcom, and Tyco securities litigation, as well as in many others. To succeed with a Section 10 claim, plaintiffs must plead and prove that the speaker made a material misstatement or omission with the requisite intent, scienter, that they relied on the misstatement or omission, and that it caused them injury.

The scienter requirement is the one that causes eliminates many cases at the pleading, or motion-to-dismiss, stage. Courts had begun to create significant pleading hurdles for these claims on their own. Then, in 1995, Congress became involved passing the 1995 Private Securities Litigation Reform Act (PSLRA), which adopted legislative language requiring heightened pleading in these cases. Since the PSLRA became law, courts have significantly increased the pleading hurdle for plaintiffs, resulting in fewer cases surviving motions to dismiss. Moreover, because the plaintiffs must plead scienter for each defendant, some defendants are more likely to be dismissed than others.

Section 10 claims now pose two significant hurdles for plaintiffs wishing to sue independent directors. First, independent directors are unlikely to be “speakers.” Second, even if they are, they are less likely than their inside director counterparts to have the requisite “knowledge” of the misstatement or omission to meet the pleading standard. Thus, courts are more likely to dismiss independent directors from complaints invoking Section 10 claims, even where the independent directors have signed the document attesting to their role in its execution. The pleading

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115 See, e.g., San Leandro Emergency Med. Plan v. Philip Morris, 75 F.3d 801, 808 (2d Cir. 1996) (holding that plaintiffs failed to establish that defendant cigarette company had the requisite intent to commit fraud when it announced that sales declines were being contained and announced substantial sales declines shortly thereafter).
118 Compare In re Nextcard, Inc., Sec. Litig., 2005 U.S. Dist. LEXIS 9234 (Finding that to meet scienter requirement, plaintiffs must plead more than that directors signed document containing misstatement or omission); In re Lernout & Hauspie Sec. Litig. v. Lernout, 286 B.R. 33, 2002 U.S. Dist. LEXIS 22708 (holding that unless outside directors have actual control over content of documents, they cannot be liable for misstatement or omissions); AUSA Life Ins. Co. v. Dwyer, 928 F. Supp. 1239 (S.D.N.Y. 1996) (dismissing independent director from section 10b cause of action and finding that independent directors do not have requisite level of scienter for misstatements and omissions in 10K), with Howard v. Everex Systems, 228 F.3d 1057 (9th Cir. 2000) (holding that insider who signs 10K can be
requirement, however, applies only to private-plaintiff causes of action. The SEC is not subject to the same pleading standard\(^{119}\) and, unlike private plaintiffs, has the power to bring aiding-and-abetting causes of action as well.\(^{120}\)

**Section 11.** The Securities Act of 1933, however, has several causes of action that do not require heightened pleading\(^{121}\) and are, therefore, theoretically easier for private plaintiffs to bring.\(^{122}\) For example, under the Securities Act of 1933, liability for the misstatements and omissions of material facts in an issuer’s registration statement attaches to all those who sign the registration statement\(^{123}\) and all directors of the issuer in office at the time of filing,\(^{124}\) as well as directors named, with their consent, as about to become directors.\(^{125}\)

As discussed at some length above, directors have a complete defense to this otherwise strict-liability cause of action referred to as the due-diligence defense.\(^{126}\) The defense supports the statutory goal of promoting accurate disclosures, by placing the burden of proof on directors (and others) to show that they did a reasonable investigation and had reasonable grounds to believe, and in fact did believe, that the registration statement did not contain misstatements or omissions at the time it became effective.\(^{127}\)


\(^{120}\) See Exchange Act § 21(e) (authorizing aiding and abetting action for SEC when acts are knowing).

\(^{121}\) Compare Exchange Act § 21D(b)(2) (requiring complaints to provide particularized “facts giving rise to a strong inference that the defendant acted with the required state of mind”) with Securities Act of 1933 § 27, 15 U.S.C. § 77z-1 (2005) (imposing no such pleading requirements);

\(^{122}\) Despite the seemingly clear choice of Congress to include this provision in the Exchange Act claims, but not in the Securities Act claims, courts have applied the pleading standard to both ’33 and ’34 Act claims. See, e.g., Rombach v. Chang, 355 F.3d 164 (2d Cir. 2004); See also Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims*, 76 WASH. U. L. Q. 537, 583-593 (analyzing statutes and arguing that courts have incorrectly applied heightened standard to ’33 Act claims); Pritchard & Sale at 138 (discussing issue).


\(^{126}\) 15 U.S.C. § 77k(b).

In addition to the due-diligence defense, there are several other hurdles for private plaintiffs wishing to sue under section 11. To begin with, plaintiffs often wish to plead both section 11 and section 10b claims in the same complaint. As discussed earlier, section 10b claims are subject to a very stringent pleading standard, frequently leading to dismissal at an early stage. Despite the fact that section 11 claims are strict liability in nature and do not, therefore, contain a scienter element, courts routinely subject the entire complaint to the heightened pleading standard under the theory that a complaint containing both types of claims “sounds in fraud.”

One solution to this problem is to file a complaint focusing only on section 11 liability. Courts, however, have significantly cabined section 11 liability, making it very difficult to claim in a case involving securities traded on the open market. The doctrine deployed in these cases is one tied to standing and called, tracing. Under the tracing doctrine, the courts find that plaintiffs who have purchased shares of stock in a particular issuer cannot pursue their claims unless they can prove in fact that their shares were actually issued pursuant to the questioned offering. Unless they purchased at the offering price, they are unlikely to be able to trace their shares to questioned offering document. As a result, if an issuer has made more than one offering of fungible shares, the plaintiffs are unlikely to succeed with their section 11 claim. The Worldcom section 11 plaintiffs avoided this fate only because they were bond holders, not fungible security holders.

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128 See, e.g., Rombach v. Change, 355 F.3d 164 (2d Cir. 2004) (holding that where complaint sounds in fraud, plaintiffs must plead all claims, including strict-liability 1933 Act claims with particularity required by fraud doctrines); Lone Star Ladies Club v. Schlotsky’s Inc., 238 F. 3d 363 (5th Cir. 2001); Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1252 (10th Cir. 1997); Shaw v. Digital Equip., Corp., 82 F.3d 1194, 1223 (1st Cir. 1996); In re Stac Electronics, Sec. Litig., 89 F.3d 1399, 1404 (9th Cir. 1996); In re FirstEnergy Corp., Sec. Litig., 316 F. Supp. 2d 581 (N.D. Ohio 2004) (holding that since fraud is not a requisite element of a § 11 or § 15 claim, such claims are not subject to the heightened pleading requirements); In re NationsMart, Corp., Sec. Litig., 130 F.3d 309, 314 (8th Cir. 1997). For a discussion of the sounds-in-fraud doctrine and an argument that the courts have misapplied it, See Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims, 76 WASH. U. L. QTLY. 537, 590-91 (1998).

129 See, e.g., DeMaria v. Andersen, 318 F.3d 170 (2d Cir. 2003) (affirming tracing requirement).

130 But see, e.g., DeMaria v. Andersen, 318 F.3d 170 (2d Cir. 2003) (holding that where issuer had only one offering of shares, plaintiffs could trace no matter when they bought their shares).

131 These issues were not raised by the director defendants in the Worldcom litigation. In re Worldcom, Inc., Sec. Litig., 294 F. Supp. 2d 392, 398 (S.D.N.Y. 2003). The defendant underwriters, however, did raise the tracing argument in their motion to dismiss. See In re Worldcom, Inc., Sec. Litig., Underwriters’ Motion to Dismiss, 2002 WL 32151688, at *4-8.
Finally, although section 11 is a strict liability statute, and thus does not normally require proof of reliance on the alleged misstatement or omission, proof of reliance is required for plaintiffs who acquired securities after the company issues an earnings statement that covers a period of twelve months after the effective date of the registration statement. If proof of reliance is required, class-action status is more complicated. For new issuers that have not yet achieved a significant market presence, the market on which the securities are traded may not be efficient. If the market is not efficient, then the court will not presume reliance. Without the presumption of reliance, the plaintiffs need to plead and prove actual reliance. However, if actual reliance is required, a class action will be difficult to pursue, because each plaintiff’s reliance may be different. Thus, reliance, particularly when combined with tracing, can be fatal to a private cause of action.

### Section 12(a)(2).

The other key claim available to private plaintiffs is section 12(a)(2). Section 12(a)(2) provides an express cause of action against sellers for public-offering misstatements or omissions in a “prospectus or oral communication.” Proper defendants under section 12(a)(2) are persons involved in the sale of the securities who are unable to prove that they did not know or “in the exercise of reasonable care could not have known” of the misstatement or omission. In addition, the defendants have a loss causation defense. Here, the defendants need to

(S.D.N.Y. Dec. 13, 2002). Although the court did not address the argument directly, it did address and reject it indirectly. See Worldcom, 294 F. Supp. 2d. at 420-21.


133 See, e.g., In re PolyMedica Corp. Sec. Litig., 432 F.3d 1 (1st Cir. 2005) (vacating class certification because the district court improperly applied a definition of market efficiency, resulting in a false presumption of reliance).

134 Id.

135 Moreover, unique reliance can defeat a potential lead plaintiff or class representative.


137 See Gustafson v. Alloyd Corp., 513 U.S. 561 (1995) (holding that only public offerings, not for example, private placements, can be subjected to Section 12(a)(2)’s reach). See also DONNA M. NAGY, RICHARD A. PAINTER, AND MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT 300-302 (discussing the transactional reach of section 12(a)(2)). The Gustafson decision sparked debate about which offerings are properly covered by section 12(a)(2). See, e.g., Stephen M. Bainbridge, Securities Act Section 12(2) After the Gustafson Debacle, 50 BUS. LAW 1231, 1260-70 (1995).

138 Nagy et. al, supra Note 137 (VERIFY—there was an “id” here to previous footnote—which source in FN 80 is this from—Nagy or Bainbridge?). To determine whether defendants have met their burden of proof on this defense, courts consider their level of participation in the transaction, their access to corporate materials, their skill and specialized knowledge, their financial interest in the transaction, and the nature of the relationship between the buyer and the seller. See, e.g., Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984) (applying these factors and holding a manager liable for misrepresentations that investors reasonably relied upon). For more on this defense, See Therese H. Maynard, The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933, 69 NOTRE DAME L. REV. 57 (1993).
prove that the misstatement or omission did not cause the fall in the price or value of the security.139 Finally, reliance is not an element of a Section 12(a)(2) claim either.140

The courts have also grafted limitations onto these claims. Many courts have applied the tracing doctrine to section 12 claims, resulting in dismissals.141 The courts have also adapted a regulation that limits the distribution requirement for a prospectus to offering purchasers to 25 days after the offering effective date, to cap limit standing to purchasers who can trace and who purchased within the 25-day period. As a result, in an initial public offering case involving plaintiffs who purchased more than 25 days after the effective date of the offering, courts have found that the plaintiffs lack standing to sue.142

The most significant limitation on section 12(a)(2) claims, however, is the increasingly stringent definition of “seller.” To hold a defendant liable, the plaintiff must have purchased securities from, or have been in privity with, the seller.143 As interpreted by the courts, sellers are those who actually sold or solicited the purchase of securities.144 Courts have used this definition to dismiss complaints and defendants who plaintiffs for whom defendants are unable to allege actual involvement in the sales process. Courts have also found that signing the offering documents, without other involvement in the sale of the securities, is insufficient for seller status.145

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140 Id.
142 See In re Valence Tech. Sec. Litig., 1996 WL 3778 (N.D. Cal.) (limiting liability for section 12(a)(2) to purchasers who were required to receive prospectus).
143 See Pinter v. Dahl, 486 U.S. 622 (1988) (defining seller for purposes of section 12 (a)(1). This definition has been extended and applied in section 12(a)(2) causes of action. See JOHN C. COFFEE & JOEL SELIGMAN, SECURITIES REGULATION, 935 n.1 (9th ed.) (citing cases).
144 Pinter, 486 U.S. at 622 (holding that seller status extends beyond just entity or person transferring title).
Other courts have been even more restrictive in their definition of seller, limiting the term to the entity or person actually transferring title.\textsuperscript{146} In a firm commitment offering, the issuer transfers title to the underwriter, and the underwriter transfers title to the public.\textsuperscript{147} Thus, under this title-based approach, firm-commitment underwriters are the only sellers. These opinions thus protect not only the independent directors from potential section 12(a)(2) liability, but also the issuer.\textsuperscript{148}

For independent directors, section 12(a)(2) liability is particularly unlikely. Although the CEO and the CFO, as well as the underwriters, are likely to participate in the sales process, independent directors are harder to tag with the requisite role in the sales process. Officer directors, like the CEO and the CFO, are frequent and obvious roadshow participants, and thus, involved in the solicitation process. Independent directors, however, are quite unlikely to participate in such events.

The remedy for plaintiffs, and the corollary deterrence mechanism, is, largely, damages for both sections 11 and 12(a)(2). For section 11, securities holders can recover damages amounting to the difference between the amount paid for the security and its value at the time of either the lawsuit or its sale.\textsuperscript{149} Under either formula, the damages are limited to the original sale price of the security.\textsuperscript{150}

\textsuperscript{146} See Shaw v. Digital Equip. Corp., 82 F.3d at 1202 (holding that plaintiffs who purchased in firm-commitment underwriting were in privity only with underwriters, not with issuers). \textit{But see} Milman v. Box Hill Sys. Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,619, at 92,813 (S.D.N.Y. Aug. 16, 1999) (rejecting issuer and individual defendants' argument that because disputed offering was "firm commitment underwriting," they were not in privity and were not sellers).

\textsuperscript{147} Shaw, 8 F. 3d at 1202.

\textsuperscript{148} The SEC recently responded to this case law, promulgating a new rule rejecting the theory of those opinions, making clear that issuers remain liable for offering misstatements and omissions in the prospectus as included in the registration statement -- regardless of the type of offering or underwriting arrangement. \textit{See} 17 C.F.R. § 230.159A (2005). The key text of this rule reads:

\begin{itemize}
  \item[(a)] Definition of seller for purposes of section 12(a)(2) of the Act. For purposes of section 12(a)(2) of the Act only, in a primary offering of securities of the issuer, regardless of the underwriting method used to sell the issuer’s securities, seller shall include the issuer of the securities sold to a person as part of the initial distribution of such securities, and the issuer shall be considered to offer or sell the securities to such person, if the securities are offered or sold to such person by means of any of the following communications:
    \begin{itemize}
      \item[(1)] Any preliminary prospectus or prospectus of the issuer . . .
      \item[(2)] Any free writing prospectus . . .
      \item[(3)] The portion of any other free writing prospectus
      \item[(4)] Any other communication that is an offer.
    \end{itemize}
\end{itemize}


\textsuperscript{150} 15 U.S.C. § 77k(g).
security holders with a cause of action for rescission if they still hold the security or, if not, damages.\textsuperscript{151} And, of course, any damages are subject to the loss causation defense as well.\textsuperscript{152} In either case, the damages are the enforcement mechanism for the securities requirements. Damages, however, require surviving a motion to dismiss. As this discussion makes clear, that is not as easy as a simple reading of the statutes might seem.

In fact, the theme that emerges from all of these private causes of action is one of increased and increasing limitations on private causes of action against independent directors. The significant nominal liability for independent directors under both sections notwithstanding, actual liability is practically nonexistent. Over time, as the private plaintiff bar became more successful at bringing claims, the legislative and judicial backlash against them increased.\textsuperscript{153} Congress and the courts actively developed various pleading standards and interpreted the statutes in increasingly restrictive ways, resulting in fewer effective private claims against independent directors.\textsuperscript{154} Thus, even though the Worldcom plaintiffs succeeded in extracting a settlement from the independent directors, their success should not be overestimated. It remains unique, as one of the only private securities actions in which the plaintiffs actually extracted damages, out of pocket, from independent directors.\textsuperscript{155}

This discussion, however, is not meant to be a defense of private litigation at all or when focused on independent directors. Private litigation is not a particularly effective or well-honed tool for enforcing the securities laws. The litigation is procedurally focused, with very little substantive case law to define its terms. It is also class-action litigation, which suffers from significant agency problems. Simply put, private securities litigation is less effective than it could be. At best, it is a blunt tool for effecting change or ensuring compliance. And, when it comes to independent directors, a blunt tool may be particularly problematic. Instead, the purpose of this quick review is to point out that with respect to independent directors, private litigation is simply not an effective deterrence mechanism. Successful litigation is unlikely and actual damage payments are exceedingly rare.

The lack of effective private remedies to enforce independent director obligations is to increase both the importance of and focus on the

\textsuperscript{154} Id.
\textsuperscript{155} Id. (finding only one case in which independent directors actually paid out of pocket to resolve state fiduciary or federal securities law case).
SEC’s role. It is left with the responsibility to ensure that directors are diligent and watchful board members and faithful securities monitors. Interestingly, the SEC appears to have recognized its role recently, though it has not yet deployed its powers. As the following discussion will make clear, those powers are very accessible and flexible. It has both “easier” to prove causes of action available to it than to private litigants and a variable set of remedies. As a result, the SEC’s role takes on even greater significance.156

Consider the SEC’s statutory powers to pursue independent directors. It can pursue independent directors for negligence with respect to misstatements or omissions in offering documents through section 17 of the 1933 Act.157 The SEC can also use section 10b. The reputational sting of a section 10b violation is arguably higher, than its section 17(a)(2) negligence counterpart, due to the presence of the scienter element, which requires proof of some degree of reckless conduct on the part of each defendant. This element makes section 10b claims harder to prove.

The SEC has the power to deploy section 17(a)(2) to misstatements and omissions in registration statements and other offering documents. Although section 11 provides a strict-liability claim for private plaintiffs, this claim is increasingly difficult for them to pursue. As a result, the SEC’s negligence actions under 17(a)(2) are likely to be the most efficacious tool for pursuing offering fraud.

The SEC also has the power to bring aiding and abetting causes of action.158 The use of aiding and abetting is a potentially powerful tool. It allows the SEC to pursue a so-called secondary actor. Secondary liability is available for non-speakers. Where the speaker (against whom primary liability is appropriate) in a section 10b-5 cause of action is the person who actually made the misstatement or omission in a press release, for example,

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157 See Aaron v. SEC, 446 U.S. 680 (1980) (holding that §§ 17(a)(2) and 17(a)(3) require proof merely of negligence, but that section 17(a)(1) requires proof of scienter). All of the circuit courts that have reviewed the question of whether section 17(a)(2) is available to private plaintiffs, however, have concluded that it is not. See, e.g., Maldonado v. Dominguez, 137 F. 3d 1 (1st Cir. 1998).
For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.
the secondary violator is one who substantially assisted in the violation. Some courts have been very restrictive in their interpretation of the reach of primary liability, restricting it to individuals or entities, like accounting firms, specifically mentioned in, for example, an allegedly misleading press release about company finances.\textsuperscript{159} Secondary liability, however, extends easily to those who are involved in the drafting of a misstatement or omission. Independent directors are, of course, more likely to participate in the draft and review stage of misstatements or omissions than to be the ones actually to do the speaking. Aiding and abetting then, creates the potential for SEC-based liability against independent directors. It is not, however, as accessible as section 17(a)(2), because proof of aiding and abetting requires proof of “knowingness.”\textsuperscript{160}

Before getting to court, the SEC’s staff conducts investigations.\textsuperscript{161} This process is also flexible.\textsuperscript{162} During this time period, staff gathers and sifts a tremendous amount of evidence, in part in an attempt to determine whether further action is warranted. Until the investigation is completed, the information remains confidential. Many investigations begin informally, and some are resolved with voluntary compliance, including interviews and documents, from issuers and others.\textsuperscript{163}

However, if the informal procedure does not resolve the matter, the staff can ask the Commission to authorize a formal investigation.\textsuperscript{164} The goal at this stage is still fact-finding, but the process is no longer voluntary. Now, the Enforcement Division has the power to subpoena testimony and documents.\textsuperscript{165} This power, subject to enforcement through the judicial system, can provide the SEC with considerable information to determine whether violations have in fact occurred.

The SEC also has the power to issue Wells calls, allowing individuals to respond and offer reasons why an SEC enforcement action

\textsuperscript{159}See, e.g., Wright v. Ernst & Young, LLP, 152 F.3d 169 (2d Cir. 1998) (holding primary liability was precluded because no false or misleading statement was attributed to the accounting firm at the time of dissemination).
\textsuperscript{162}See, e.g., U.S. v. Morton Salt Co., 338 U.S. 632, 652 (1950) (holding that if “inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant,” courts should not intervene).
\textsuperscript{163}See COFFEE & SELIGMAN, supra Note 143, at (X)
\textsuperscript{165}See 17 C.F.R. §§ 201.150, 201.232(c) (2005).
would be inappropriate.\textsuperscript{166} SEC staff issue Wells notices in a discretionary, but customary manner, during a formal investigation. The usual timing for a Wells notices is at the point when the staff is preparing to request Commission approval to initiate enforcement action.\textsuperscript{167} Thus, Wells submissions can provide a subject of an investigation with an opportunity to exculpate themselves before the enforcement action is initiated.\textsuperscript{168} These submissions offer the subject’s side of the story, theoretically, focusing on legal and policy issues, to persuade the Commission not to bring the case.\textsuperscript{169} In reality, the submissions generally address the facts.\textsuperscript{170}

At the conclusion of the formal investigatory stage, if staff has determined that a violation of the securities laws occurred, it will request that the Commission take remedial action. The enforcement actions adopted by Commissioners can take the form of civil prosecutions in federal district court for violations of, for example, Section 17(a)(2) or Section 10(b), requesting injunctive relief and disgorgement, as well as monetary penalties and director and officer bars.\textsuperscript{171} Typically, the announcement of the action is combined with an announcement of the settlement on the part of the defendants, although defendants generally neither admit nor deny liability.\textsuperscript{172}

Alternatively, the Commission can proceed administratively, using the process and remedies prescribed under both the Securities Act and the Exchange Act.\textsuperscript{173} The procedures set forth in Section 21C of the Exchange

\textsuperscript{166} See, e.g., Corporate Governance: SEC Official Says Enforcement Staff Seeking Actions Against Independent Directors, BNA Sec. Reg. & L. Rpt., 37 SRLR 2098 (Westlaw Dec. 19, 2005) (discussing the SEC’s decision to issue Wells notices to two companies).

\textsuperscript{167} See COFFEE AND SELIGMAN, supra Note 144, at 1557-58. Although the Commission has endorsed the procedure for Wells Notices, it has never, as a matter of rulemaking, adopted a formal requirement that Wells Notices be issued. See 1973 SEC LEXIS 3173 (Mar. 1, 1973) (declining formally to adopt a requirement that all prospective defendants/respondents “be given notice of the staff’s charged and proposed enforcement recommendation and be accorded an opportunity to submit a written statement to the Commission”). See also SEC Rules of Practice, 17 C.F.R. § 202.5 (2005) (delineating enforcement practices and making voluntary Wells submissions available). The Wells notices and submissions received their name from the chair of the SEC’s Advisory Committee on Enforcement Policies, which recommended the process in the 1970s.

\textsuperscript{168} id.

\textsuperscript{169} id.

\textsuperscript{170} id.


\textsuperscript{172} See generally, Report of the Task Force on SEC Settlements Prepared by the Subcommittee on Civil Litigation and SEC Enforcement Matters of the Federal Regulation of Securities Committee of the ABA’s Section on Business Law, 47 BUS. LAW. 1083 (1992) (discussing generally the SEC settlement process and naming several cases where defendants settle with the SEC without admitting or denying liability).

\textsuperscript{173} See Exchange § Act 21C, Securities Act § 8A.
Act and Section 8A of the Securities Act, allow the Commission, after
notice and an opportunity to be heard, to publish its factual findings and
conclusions of law. If the Commission uses this procedure and determines
that a violation has occurred or is occurring, it can then issue a “cease and
desist” order. 174 The statutory language giving the Commission this power
is quite broad, stating that the Commission may issue an order requiring
both the person who has violated or is violating the law as well as “any
other person that is, was, or would be a cause of the violation, due to an act
or omission the person knew or should have known would contribute to
such violation.”175 These orders require their subjects to “cease and desist
from committing or causing such violation and any future violations.”176
The orders can also require specific changes or steps necessary to achieve
compliance or future compliance with the securities laws.177 With this
process, the Commission can order disgorgement and a bar for service as an
officer or director.178

Finally, the Commission can choose to make use of the report
procedure pursuant to section 21(a) of the Exchange Act.179 Section 21(a),
authorizes the Commission to publish a description of its investigation and
the violations of the federal securities laws it has detected. The report may
be the sole outcome of an investigation, resulting in reputational, but non-
legal sanctions. These reports can also set forth prescriptions for action
and responsibilities. With respect to directors, the Commission has issued
reports to focus “attention on the responsibilities of directors of
corporations and . . . generate[] discussion and debate concerning the
governance of publicly-held corporations.”180 As a result, the reports also
create a form of “common law” describing directions and guidance from the
Commission.181 These reports are an important source of information on
how the SEC views the securities monitoring role of independent directors.

As this discussion reveals, the SEC also has powerful remedial
powers that extend well beyond the standard damages private plaintiffs win

174 Exchange Act § 21C(a).
175 Id.
176 Id.
177 Id.
178 Exchange Act §§ 21C(e) and 21C (f).
179 Exchange Act § 21(e).
180 The Commission’s Practice Relating to Reports of Investigations and Statements
Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of
1934, The Commission’s Practice Relating to Reports of Investigations and Statements
Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of
181 For a criticism of the Commission’s use of Section 21(a), see id. at *4, Separate
Statement of Commissioner Karmel; Roberta S. Karmel, REGULATION BY PROSECUTION:
THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982). See also
Donna Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters:
when they succeed with a claim.\textsuperscript{182} Although the SEC can, of course, pursue payments from defendants, its remedial powers have perhaps the most potential for energizing the securities monitoring role of independent directors.\textsuperscript{183} For example, the Sarbanes-Oxley Act extended the reach of the director and officer bars, making them available on a permanent basis for violations of section 10(b), with proof merely of “unfitness” to serve.\textsuperscript{184} Additionally, the SEC now has the power to impose these bar orders administratively, again tied to section 10(b) violations.\textsuperscript{185} Although the bar orders are not available for violations of the negligence-based provisions of section 17(a)(2), their power has not gone unnoticed.\textsuperscript{186}

Moreover, a bar order, even if temporary, would produce shame or reputational dishonor for an independent director and, presumably, act as an incentive, and in some cases a deterrent, for other independent directors.\textsuperscript{187} The corporate director community is arguably sufficiently small and insular enough to make the power of a shaming sanction particularly strong.\textsuperscript{188} To make the threat real, however, injunctions must issue, even if infrequently.\textsuperscript{189} This remedial power, then, is quite significant, and, of

\textsuperscript{182} See supra notes __ - __.

\textsuperscript{183} See, e.g., Exchange Act § 21(d), 15 U.S.C. § 78u (2005); Securities Act § 20(d), 15 U.S.C. § 77t (2005) (allowing SEC to request preliminary injunctions or temporary restraining orders for persons who have violated, or are about to violate, the securities laws).

\textsuperscript{184} Exchange Act § 21C. The statute provided a similar amendment for violations of section 17(a)(1) of the 1933 Act. Securities Act of 1933; 15 U.S.C. 77h-1(f) (2005). Before the Sarbanes-Oxley Act, the Commission had the power to request such bars in federal district court, but the standard of proof was set at “substantial unfitness to serve.” Now, the Commission has the administrative power to issue bar orders at the lower standard.

\textsuperscript{185} Exchange Act §21C (f).

\textsuperscript{186} See Deborah Solomon, Executives On Trial: Criminal Convictions of Stewart, Bacanovic Aid SEC’s Civil Case, WALL ST. J., Mar. 8, 2004, at C1 (stating that Stewart “had resisted a settlement because the SEC wants to bar her from serving as an officer or director of a public company”); Patricia Sellers, Remodeling Martha: The inside story of how the unsinkable Ms. Stewart staged her comeback--transforming her board, remaking public opinion, invading prime time. Now the hard part: making it last, FORTUNE , Nov. 14, 2005, at 100 (quoting Stewart as saying she does not want “to be told that [she] can’t be a corporate office,” which is what the SEC may be asking for in settlement talks).


\textsuperscript{188} See id. at 1811 (noting that shaming works best in close-knit communities).

\textsuperscript{189} Black, Cheffins, and Klausner, supra note 155, at ___ (concluding that some actual liability for independent directors is important for ensuring deterrence); Kahan, Social Influence, supra note 187, at 351 (arguing that legality influences and shapes perceptions of appropriate behavior).
course, unavailable to the private plaintiffs. Certainly, bringing a major case against independent directors would “have a significant impact inside boardrooms throughout America.”\textsuperscript{190} To date, however, such cases are nonexistent.\textsuperscript{191}

Of course, to say that the SEC has enforcement powers that are potentially more accessible and flexible than the private plaintiff actions is not to say that they are free of problems. SEC enforcement actions do not generally present the lawyer-driven, strike-suit problems that private litigation does. SEC personnel do not have to earn attorneys fees to survive. Thus, they do not have collect and review documents unrelated to the matter, to justify their hours or fees. Further, the informal process allows for early resolution of matters. That being said, although companies can decline to participate in informal investigations, they rarely do so, in part, because cooperation early and often is a factor in determining sanctions. Thus, some arguably inappropriate pressure might exist. Nevertheless, the SEC process is arguably more efficient than private litigation. It avoids the procedural loops of the motion-to-dismiss process. It allows for targeted actions against specific individuals who have had the opportunity to respond and defend themselves. And it provides for remedies not available to private litigants. Seemingly, then, targeted SEC enforcement actions against independent directors could be a powerful incentive to animate the securities monitoring role. Nevertheless, the SEC’s efforts against independent directors have been very limited.

Consider the SECs enforcement efforts since Enron. The SEC has certainly stepped up enforcement. It has settled more enforcement actions against larger, and “higher profile” companies than prior to Enron.\textsuperscript{192} Yet, significantly, these enforcement matters have not targeted or resulted in settlements with independent directors. A review of various SEC documents reveals that the SEC has pursued few independent directors – at any size company.

\textsuperscript{191} I have found a couple of earlier cases involving independent directors, but the circumstances of those cases are not of the “securities monitoring” type. For example, in 1993, the SEC instituted a 21C proceeding against William Wilson, an independent director of the Earle M. Jorgensen Company. See In the Matter of William A. Wilson, 1993 SEC LEXIS 1281 (June 1, 1993). Wilson was an independent, but not actually independent, director of the company. He engaged in business transactions with the company, but failed to disclose them in when he reviewed and approved the company’s 14D9 tender offer form.
\textsuperscript{192} James D. Cox, Randall S. Thomas, and Dana Kiku, Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron, 80 NOTRE DAME L. REV. 3 (2005) (providing empirical study of pre- and post- Enron SEC settlements, concluding, in part, that settlements with larger companies and “higher profile” cases are more recent phenomenon).
A recent SEC report pursuant to section 704 of the Sarbanes-Oxley Act confirms the dearth of actions against independent directors.\textsuperscript{193} Section 704 required the SEC to study enforcement actions for the five years prior to the enactment of Sarbanes-Oxley in an effort to determine which areas of financial reporting, like earnings management, are most susceptible to fraud. This study, although not focused on independent director issues, is quite revealing. To complete the study, the SEC reviewed all of its enforcement actions filed from July 31, 1997 to July 30, 2002 that “were based on improper issuer financial reporting, fraud, audit failure, or auditor independence violations.”\textsuperscript{194} According to the report, during that time frame, the SEC filed 515 enforcement actions arising out of 227 enforcement investigations.\textsuperscript{195} In the 515 actions, there were 869 named parties.\textsuperscript{196} Of those parties, 164 were entities and 705 were individuals.\textsuperscript{197} 

Of the 705 individuals, none were independent directors. Instead, they were senior management members, mid-level management, lawyers, and customers.\textsuperscript{198} Of course, in some of the enforcement actions, the SEC charged directors with securities violations.\textsuperscript{199} All of the directors charged by the SEC, however, were also company officers or inside directors.\textsuperscript{200} The same appears to be true today.

Indeed, a recent statement by an SEC enforcement official confirms this point. In an American Bar Association Section of Business Law program, Peter Bresnan, the deputy director of the SEC’s enforcement division stated that the division is recommending that the SEC “bring actions against independent directors in cases [already] pending on the

\begin{footnotesize}

\textsuperscript{194} Id. at 5.

\textsuperscript{195} Id.

\textsuperscript{196} Id.

\textsuperscript{197} Id. I have found only one, non-insider trading case where the SEC settled with an independent director since the date of the above-mentioned report. Securities and Exchange Commission v. Chancellor Corporation, et al., (United State District Court for the District of Massachusetts C.A. No. 03-10762 MEL) Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 2230/ April 11, 2005. In this case, the SEC settled with Rudolph Peselman, an independent director. Although he did not admit to the allegations, he did agree to an injunction barring him from serving as a director or officer of any public company.

\textsuperscript{198} Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, supra Note Error! Bookmark not defined., at 2 (listing categories in contents).

\textsuperscript{199} Id. (noting that 75 board chairs were charged).

\textsuperscript{200} Id.
\end{footnotesize}
agency’s calendar.” If the SEC were to approve these actions, they “would be the first such cases in some time.”

Importantly, however, Bresnan further indicated that the SEC has issued Wells calls in cases currently on the enforcement docket in which possible “independent director charges are being contemplated.” Some evidence exists of Wells notices to independent directors. For example, in the case of the Biopure, Corp., the SEC issued Wells notices to four individuals, two independent directors and two others. Later, however, the SEC filed a complaint against Biopure, one officer, and one employee, but it did not name the independent directors. The SEC has also issued Wells Notices for independent directors on the audit committee of Hollinger International, Inc. for “allowing an alleged fraud to take place under their nose.” Between Bresnan’s comments and the Hollinger example, it appears that the SEC may be late to the table, but is paying increasing attention to the independent directors’ role as securities monitors.

Bresnan’s comments may indicate that the SEC is currently viewing its more narrowly than the statutes and its own releases might indicate. For example, Bresnan noted that “the division will pursue cases in which the independent director ‘has taken no care in ensuring the accuracy of the statement [he or she] make[s].’” As discussed above, independent directors make very few actual statements. When they do, they are much more likely to face a successful private plaintiff cause of action. Further, because independent directors rarely speak publicly about the companies for which they work, their key role is not as “speakers” per se, but as securities monitors. However, it is possible that with the current enforcement climate, the SEC may well choose to expand its enforcement efforts against independent directors. The last section of this article explores the types of situations which might prompt SEC investigation and action.

Situations Implicating Securities Monitoring Duties.

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201 Corporate Governance at p. 1.
202 Id. Older cases exist. See National Telephone Release, supra Note 58, at 1 (issuing a report pursuant to section 21(a) of the Exchange Act . . . need to fill in rest of FN-not sure what info)
203 Id.
207 See supra notes . . . . .
An examination of prior SEC documents and current statements reveal several factual scenarios that are likely to receive attention from the SEC and additional focus on the roles of independent directors to determine whether enforcement action is warranted. For example, according to the SEC, more issuer fraud occurs through improper revenue recognition than in any other way.\textsuperscript{208} In simple terms, improper revenue recognition occurs when issuers record revenues, before they should do so under accounting rules and guidelines. For example, when an issuer records items as sold, and recognizes the revenue for accounting purposes, while the products are still subject to a right of return, it has likely engaged in revenue-recognition fraud. Improper expense recognition fraud cases are a second significant group. Capitalizing or deferring expenses can make a company’s bottom line look better just as inflating revenues can.\textsuperscript{209} The key question for SEC enforcement is which types of, for example, revenue-recognition frauds are likely to attract its attention. This section of the paper develops some scenarios that appear likely to attract SEC attention to the securities monitoring role of independent directors.

Consider fraud cases involving public offerings of securities. As discussed earlier, private plaintiffs have an explicit cause of action, against a list of defendants that includes independent directors, for misstatements and omissions in a registration statement. The courts, however, have significantly eroded the cause of action making it difficult for private plaintiffs to succeed on their own and increasing the importance of SEC attention. Other scenarios likely to attract increased attention include those involving: known but undisclosed fraud; long-term revenue recognition fraud; short term, but unusual revenue-recognition fraud; and fraud in a field or area of independent director expertise. Each type of situation is described in more detail below.

**Public Offering Fraud.** As discussed earlier in this paper, misstatements and omissions concerning public offerings of stock are arguably one of the most troubling types of fraud. The insider-trading like nature of these situations combined with the increasingly inaccessible private causes of action warrants greater SEC attention. In open-market offerings, the securities laws and regulations provide a similar sort of blueprint for ensuring that investors have access to information about the company. If the issuer does not provide the full and accurate disclosure, they are arguably cheating the investors while enriching themselves. The

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\textsuperscript{209} Id.
situation is sufficiently unsavory as to attract greater SEC enforcement efforts.

Section 11, of course, was designed to provide a private, strict-liability remedy for such lapses. Although the SEC would not proceed under section 11, a section 17(a)(2) proceeding is arguably much like the section 11 claim combined with the due-diligence defense. The defense, of course, exists because we expect directors to engage in due diligence and do not want to sanction them if they did and were themselves victims of fraud. From the SEC’s perspective, when the independent directors do not engage as securities monitors and fail to ask questions and set up systems, they are properly subject to SEC enforcement provisions. In addition, given the ways in which the courts have circumscribed the likelihood of successful private plaintiff action in these cases, the SEC might increase its focus on offering cases that involve misstatements and omissions, investigate independent directors who have signed the documents, and, where appropriate, sanction directors who were negligent or who failed to exercise appropriate due diligence.

Consider an SEC section 21(a) report discussing the failure of independent directors to perform their securities monitoring roles in a company engaged in public offerings. In the Stirling Homex report, the SEC describes its investigation of the company, its initial public offering, and a secondary one. In short, the company went public and, according to the SEC, immediately “embarked on a fraudulent course of conduct designed to show continually increasing sales and earnings.” While it was recording “fictitious sales, earnings, and assets,” the company issued several false and misleading public statements, including press releases, periodic reports, and registrations statements. Within a year of its initial public offering, the company was suffering from cash flow problems and decided to make a second stock offering of preferred stock. The offering proceeds, however, did not resolve the company’s problems. It was unable to ship its products or to collect on its accounts receivables. Eventually, the company was forced to announce substantial losses, which the SEC attributed to its earlier recordation of false sales. Not long after making this announcement, the company filed for bankruptcy.

When the SEC explored the reasons for the company’s failure and the optimistic public statements, it discovered and documented several ways

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210 Stirling Homex Release, supra Note 59.
211 Id.
212 Id.
213 Id.
214 Id.
215 Stirling Homex Release, supra Note 59.
216 Id.
217 Id.
in which the independent directors had failed to perform their jobs as securities monitors. For example, from the initial public offering to the company’s bankruptcy, a two-year period, the board of directors met only seven times, mostly over the phone, and perfunctorily.\textsuperscript{218} In fact, the company held no board meetings at which all members were actually present.\textsuperscript{219} Rather than the entire board functioning as the company’s key decision making body, the SEC found that it deferred to an executive committee, made up of the inside directors who perpetrated the fraud.\textsuperscript{220} Additionally, the SEC specified several ways in which the board failed to take the active role necessary to fulfill its securities monitoring requirements.\textsuperscript{221} For example, the SEC criticized the board for its failure to create committees to assist with its responsibilities and to solicit information from management. It also noted that board meetings did not proceed with a written agenda or memoranda describing proposals.\textsuperscript{222}

Even when the independent directors complained or requested information, the SEC noted that they failed to follow through. Thus, the SEC noted that between the first and second offerings, one independent director complained about the “arbitrary” way in which the CEO ran the meetings and the refusal of company management to provide the board with financials.\textsuperscript{223} He was reassured that the information would be forthcoming.\textsuperscript{224} It was not.\textsuperscript{225} Then, he read an article in the news that criticized the company’s accounting practices.\textsuperscript{226} He renewed his inquiry for further information.\textsuperscript{227} This time he was told that “the company’s accounting practices and auditors had been changed.”\textsuperscript{228} A few months later, he tendered his resignation, asserting that “he had not been receiving sufficient information from the company to be well informed of its affairs.”\textsuperscript{229} He was, however, persuaded to stay on the board.\textsuperscript{230}

Shortly thereafter, he signed the registration statement for the second offering without raising any further questions about the financials,
consulting with the auditors, or questioning the investment bankers. Indeed, the SEC had questioned the company about the offering before allowing it to proceed, but the officers did not tell the independent directors. According to the SEC, the failure of the independent directors to engage in active questioning resulted in the offering going forward with the directors' signatures and a lack of due diligence. 

After reciting several very serious factual circumstances that should have put the independent directors on notice that more active securities monitoring was required, the SEC set forth its views on the “functioning of independent directors in a particular” investigatory setting.” The SEC’s comments are worth reporting in full:

There existed no internal system by which the [independent directors] were regularly provided with significant information concerning corporate affairs and to some extent they recognized this deficiency. For example, [they] were not normally provided with financial projections, corporate development plans or the status of corporate contracts and agreements. In the Commission’s opinion, they did not obtain a sufficiently firm grasp of the company’s accounting practices and other aspects of the company’s business related thereto to enable them to make an informed judgment of its more important affairs or the abilities and integrity of its officers. [The independent directors] relied upon the fact that Stirling Homex’s independent accountants had accepted these accounting practices as being in conformity with generally accepted accounting principles. While this reliance was understandable, it resulted in their making no significant effort to analyze or familiarize themselves generally with these accounting practices, and in the opinion of the Commission, it resulted in their failure to understand the implications of these accounting practices and their susceptibility to abuse. While they periodically asked general and conclusory questions, they frequently obtained only superficial answers which they accepted without further inquiry.

Of course, with hindsight and this description, it is easy to say that these directors were particularly supine and deserving of the shame heaped on them in this report.

231 Stirling Homex Release, supra Note 59.
232 Id.
233 Id. at 300.
234 Id.
The report, however, does more than point out a particular, egregious situation involving independent director behavior. It reflects a clear and strong position from the SEC about the securities monitoring role of independent directors in general and in the context of public offerings in particular. To be sure, independent directors face a particularly difficult situation when management embarks on a complex fraud scheme.\footnote{Id.} But, when there are flags or missing information, independent directors have a duty to ask, to press, to move aggressively.\footnote{Stirling Homex Release, \textit{supra} Note 59. \textit{See also} Report of Investigation in the Matter of the Cooper Companies, Inc., as It Relates to the Conduct of Cooper’s Board of Directors, Release No. 34-35082, 1994 SEC LEXIS 3975 (Dec. 12, 1994).} Although the Stirling Homex independent directors did not resign, section 11 provides protection for directors who cannot get the information they need to fulfill their securities monitoring role and who resign. The SEC should treat independent directors similarly.

More interestingly, although the report makes clear that the role of independent directors as securities monitors bears similarities to their state law fiduciary duties, it also makes clear that these duties are not solely a matter of state law. According to the Commission, independent directors are on the board for a reason. Their job is to question and ensure that they understand the answers sufficiently before allowing a situation to go forward or continue. In this case, according to the SEC, the directors “did not provide the shareholders with any significant protection in fact, nor did their presence on the Board have the impact on the company’s operations which the shareholders and others might reasonably have expected.”\footnote{Id.}  

\textbf{Known Fraud.} It seems straightforward. If the management is engaged in a fraud and the board knows, the board should be ensuring that company disclosures are complete and accurate. Yet, even in such an obvious area, the Commission has been forced to issue reports, chastising the independent directors for their securities monitoring failures.\footnote{See Cooper Release No. 34-35082, 1994 SEC LEXIS 3975; \textit{See also} In the Matter of Incomnet, Inc., Joel w. Greenberg, and Stephen A. Caswell, Securities Release No. 40281, at *21 (July 30, 1998) (“When information that comes to the attention of directors indicating that the corporation’s management may have engaged in fraud or that the corporation’s prior public statements may be inaccurate, corporate directors have a duty under the federal securities laws to over\textit{see} the corporation’s financial reporting process and to ensure the integrity and completeness of public statements made by the corporation.”}  

In the Cooper’s case, the SEC investigated and brought charges against three officers of the company for engaging in a frontrunning scheme, trading fraudulently in securities, and manipulating debenture prices.\footnote{Incomnet Release, \textit{supra} Note 238, at *2.} In addition, two of the officers were indicted by a federal grand
jury and convicted on many criminal counts. Yet, throughout the SEC investigation, the board allowed the insiders to continue their roles with the company and failed to ensure that prompt and accurate information was released publicly. The result was an SEC report stressing that the directors “have a significant responsibility and play a critical role in safeguarding the integrity of the company’s public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention.” Once the accuracy of outstanding reports and statements is called into question, it becomes “incumbent” on the board to monitor and ensure that public statements are candid and complete. Again, this seems like a “no-brainer,” but apparently it was not.

In its recitation of the facts of the investigation and circumstances of this case, the Commission noted that as early as January of 1992, it issued a formal investigation order. Two weeks later, the company filed its 10-K and stated that there was an SEC investigation with which it was fully cooperating. Approximately three weeks later, however, the insiders asserted their Fifth Amendment privileges, refusing to provide any information to the Commission. Despite this fact, a few days later, the board elected one of the insiders to the position of Chief Operating Officer, primarily responsible for activities and information to and between the board co-chairs, the department of finance, the legal department, and the operating units. The next month, the board was informed of possible criminal charges. The board did not disclose any of this information to the shareholders.

According to the SEC, the board did authorize independent counsel to conduct an internal investigation. Shortly thereafter, however, the board was informed that the insiders had refused to be interviewed by the independent counsel. By April, the board had become aware of a series of problematic transactions by the insiders, many of which, under company procedures and SEC regulations should have been disclosed to the board and the shareholders much earlier.

The key problem was that the board failed to make any disclosures to the public about the increasingly serious nature of the situation, including

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240 Id. at *3.
241 Id. at *4.
242 Id.
243 Id. at * 7.
244 Incomnet Release, supra Note 238, at *2.
245 Id. at *8.
246 Id. at *8.
247 Id. at *9.
248 Id. at *9.
250 Id. at *10.
that the officers had refused to cooperate with the internal investigation, until forced to respond to press inquiries when the insiders appeared in court in May.251 At that point, the board issued a statement to the press which indicated that it was reviewing the allegations and was “unaware of any wrongdoing on the part of its officers or employees.”252 Given the investigations to that point, this statement appeared to be patently false. And, the SEC said so.253 Further, it was not until another week had passed, and over a month after the actual event, that the company publicly announced that the officers had refused to cooperate with the internal investigation or the Commission itself.254

In light of the ongoing investigations and prosecutions, and the board’s failure to inform the investors of the status of the problems, the SEC decided to issue a section 21(a) report. In addition to an extremely lengthy recitation of the events and their chronology, the SEC opined on the directors’ failure as securities monitors. The SEC noted particularly that throughout much of the investigation, and even after actual evidence of wrongdoing existed, the board had failed to update the public and investors. The SEC also stated that it “consider[ed] it essential for board members to move aggressively to fulfill their responsibilities to oversee the conduct and performance of management and to ensure that the company’s public statements are candid and complete.”255 The Commission referred to and adopted state law fiduciary duties as part of the role of securities monitors, noting that it had “long viewed the issue of corporate governance and the fiduciary obligations of members of management and the boards of directors of public companies to their investors as an issue of paramount importance to the integrity and soundness of capital markets.”256 It concluded by noting that when the board is faced with actual knowledge of violations or potential violations, the securities monitoring role is particularly acute.257 The board at Coopers, the Commission said, failed to “satisfy its obligations . . . [when] it failed to take immediate and effective action to protect [its] investors.”258 Its failure so to act created an appearance that it preferred to keep “secrets” for management than to provide full and accurate disclosures as required under the securities laws.259

The Cooper board’s failure to take immediate action to inform shareholders of actual wrongdoing and to assert more control over the

251 See id. at 8-13.
252 Id. at *12.
253 Id. at *12.
254 Incomnet Release, 238, at *13.
255 Id. at *18-19.
256 Id. at *19.
257 Id. at *19.
258 Id. at *20.
259 Incomnet Release, supra Note 238, at *20.
processes leading to disclosure is particularly troubling. If faced with a situation as extreme as this one, the SEC is likely to investigate the board and take action against independent directors who did not fulfill their securities monitor role. Given the actual knowledge of the directors of the problems within the company, this case presents fairly easy evidence of scienter. Scienter, of course, is the element of section 10b claims that can be more difficult to prove against independent directors. When it exists, however, and particularly in a “known fraud” situation, the SEC might well begin to take a strong stand. With this type of fact pattern, for example, the SEC could reasonably proceed with permanent director bars, sending the message it takes the securities monitor role of independent directors very seriously.260 Even in a situation less extreme, perhaps not involving multiple indictments, but revealing ongoing bad behavior by officers and directors who fail to act aggressively to ensure full, fair, and accurate disclosures, the SEC might intervene and consider whether disgorgement of directors fees or stock options or simply issuing a section 21(a) report will set the right tone. Again, unlike the private plaintiffs who can only sue for damages, the SEC’s remedial tool kit is extremely flexible.

**Ongoing Revenue-Recognition Fraud.** Given its own discovery that revenue-recognition fraud is the most common sort of fraud perpetrated by issuers, the SEC is also likely to focus on cases involving long-term revenue-recognition fraud.261 Of course, the perpetrators of such frauds are most likely to be insiders. Independent directors, however, are securities monitors tasked with working to prevent such situations through active and engaged questioning and review of company documents. The excuse of not understanding the financials or transaction is insufficient unless supported by appropriate proof of diligence and reliance on experts. Today, public companies listed, for example, on the New York Stock Exchange are required to have an audit committee composed entirely of independent directors. The point of requiring this type of “independence” is to ensure that the directors play an active monitoring role over the company’s financials.

When the SEC is confronted with a situation involving multiple quarters, or even years of revenue-recognition fraud, it may well ask what those directors were doing while the fraud was being perpetrated. Of course, insiders can lie to the directors, and create false documents to prevent even diligent directors from discovering the revenue-recognition situation. But for cases that extend over multiple quarters or years, the directors have arguably had more time to catch the problems, to ask good and persistent questions, to pursue any red, or even pink, flags, and to ensure sufficient reporting and review systems are in place. Arguably, longer term situations increase, rather than decrease, the securities

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261 Cite to Macey.
monitoring role of independent directors. Although company insiders might be able to keep the board from knowing about a significant accounting problem or financial irregularity for one quarter or two, it stands to reason that diligent and active independent directors would ask sufficiently probing questions to prevent such situations over the longer term. Of course not every director can or will necessarily understand all of the complex financial transactions in the company. For such directors, reliance on peers, for example the audit committee, is appropriate. Before accepting that reliance argument, however, the SEC is likely to want to know whether the non-committee members have asked enough questions to assure themselves that the committee is fully engaged in its securities monitoring tasks. Thus, when the SEC is confronted with a significant revenue restatement, it is likely to be increasingly diligent in investigating whether the directors performed their securities monitor role or whether the financials presented to them contained red flags. In cases in which the directors were in fact lied to by officers and employees and were not reckless in their failure to detect the fraud, the SEC may well terminate the investigation without charges. However, considerable time, energy, and expense may occur before that SEC does so. The implication is that directors need to be able to show, with appropriate documentation in the minutes, that they have been sufficiently engaged.262

**Director Expertise.** The SEC is also likely to focus its enforcement efforts on situations in which the independent directors have particular expertise that would allow them to evaluate the financials or other documents. Lawyers and accountants are obvious board members with expertise that deserve a sliding scale of SEC review.263 The SEC has indicated in the past that it considers expertise to be an important factor for measuring appropriate due diligence.264 As the *Worldcom* court noted, independent directors who have expertise face a higher burden to establish they have met their due diligence obligations.265 Thus, it is likely to be a factor when a possible enforcement action is contemplated as well.

Another type of expertise that might come into play is industry-specific expertise. For example, in a company that is in a highly-regulated industry, like pharmaceutical companies, board members with Food and Drug Administration experience or expertise are, presumably, on the board for that reason. They should be paying more attention to company regulatory filings and the systems designed to ensure clean and accurate

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262 *Cf.* Disney cite.
264 *See supra* notes __ and accompanying text.
265 *See supra* notes __ and accompanying text.
paperwork. If they have not put their expertise to work for the company, and the fraud occurs in their area of expertise, then the SEC may focus on whether those independent directors have fulfilled their board functions as securities monitors. A similar case can be made for other companies in highly-regulated sectors.

**Other Situations.** Although less common, other circumstances may also provoke SEC attention. Consider a company that makes a series of positive statements about its prospects. Instead of being upbeat, other companies within the same industry are issuing more pessimistic statements about their prospects to the media or are downplaying earlier upbeat information. Independent directors who are monitoring company disclosures and the rest of the industry might reasonably catch such an anomaly and pursue it. Indeed, directors fulfilling their role as securities monitors should be following industry prospects and their competitors’ public statements. When a contrast in outlooks exists, the independent directors should be asking questions of the CEO and other insiders to determine that their own company’s statements are accurate. Their job as directors is to understand why their company’s situation is different than others within the industry. Their failure to do so, when it results in fraudulent public statements is arguably a breach of their securities monitoring duties that the SEC might choose to pursue.

**Conclusion**

Taken together, the scenarios described above, provide an initial roadmap of situations the SEC might decide to pursue. As the SEC has made clear, when serious fraud occurs, it now intends to broaden its focus to include all of the possible contributors. Although some of the people only have been negligent, the SEC has statutory power to pursue those types of cases. Given its statement that it intends to expand its enforcement efforts to the role of independent directors as securities monitors, it seems likely that some sanctions will occur. As this article reveals, as defined by the courts and the SEC, this director role bears resemblance to state law fiduciary duties. Importantly, however, when misstatements or omissions occur, the role is really one of securities monitoring.

The securities laws and regulations charge directors with the responsibility of monitoring disclosures and ensuring accuracy. If, at any time, independent directors become aware of potential discrepancies or actual inaccuracies, it is their job to question, discover, and correct. If they fail do so, the SEC has clearly found that they have failed to fulfill their duty “to oversee the corporation’s financial reporting process and to ensure the integrity and completeness of public statements made by the corporation.”266 The SEC has also made clear its opinion that in some

266 See Incomnet Release, supra Note 238, at *21 (July 30, 1998).
cases, if the issuer or its officers are making misstatements and omissions, the directors may have contributed to the problem even they were not themselves the actual speakers. When the SEC encounters these types of situations, it is now likely to expand its investigation to include the role of the independent directors.

Although independent directors are not responsible for every single company statement or all of the company’s securities compliance, but, certain directors may be well-situated to achieve better securities compliance. The independent-director composed audit committee is one specific example. The requirement that certain directors sign company filings is another. These requirements are not state-law requirements. They are federal regulatory and self-regulatory, with SEC approval, requirements are purposefully designed to create director duties. The purpose of a signature requirement is to remind directors that they are tasked with a securities monitoring role. The information-forcing-substance nature of the SEC’s disclosure method is designed to push vetting, questioning, and cleansing before disclosures are made. The SEC’s views its duty as ensuring enforcement of the required disclosures.

In the case of independent directors, it can do so with specific, targeted cases and remedies. As the discussion in part three of this article makes clear, the SEC has a wide range of sanctions available to it. For minor cases, it might choose the simple reputational sanction, is implicated in a section 21(a) report. Alternatively, it could focus on a reporting violation charge under section 13 of the Exchange Act. Although it can charge only the issuer with such a violation, it could choose to bring a cease and desist order against the directors along with the section 13 charge. This strategy avoids tagging the directors with negligence, but provides a hook for a sanction. Importantly, the SEC has the power to develop an entire sliding scale of other sanctions, like temporary bars for directors, or disgorgement of the director’s pay or stock options for the year in which the fraud occurred. Of course, in more serious cases, it might choose to pursue actual factual findings in a section 21(c) report or a permanent bar. The point is that the SEC has a range of options for both its actions and its remedies that are considerably more flexible than those available to private plaintiffs.

Of course, the SEC must pick its cases with care. Directors, particularly independent directors, already have significant portfolios. The pressure on them continues to grow, resulting in discussions about (though no evidence of) possible shortages. It is conceivable that any serious increases in liability might be the tipping point. That being said, several

267 See, e.g., Director Recruitment: Candidates Seen as More Cautious But Not Saying ‘No’ to Serving on Corporate Boards, BNA’s Corp. Counsel Weekly 6 (Feb. 8, 2006) (noting that potential directors are expressing caution, but no shortage exists).
independent directors from Worldcom and other troubled companies continue to serve on public company boards, indicating that at least for some, having to pay out of pocket did not deter them from continuing service as board members.\textsuperscript{268}

Further, as the independent directors continue to assert themselves, it is possible, though again to date not supported with evidence, that friction will develop in board rooms and crowd out the directors other important roles, for example, as strategic advisors.\textsuperscript{269} Interestingly, there are, in fact, indications that greater independence and monitoring is actually improving CEO and board relations, as CEOs and boards focus on better communication and content at board meetings. Moreover, it appears that boards feel empowered to focus on the corporate strategy and push for internal information to back up statements about the achievement of goals, indicating that shareholders may well receive some benefit.\textsuperscript{270}

Finally, the SEC should also move slowly and act with care because its lines of authority, though clearly and reasonably connected to corporate governance and fiduciary duties are still limited to disclosure-based violations.\textsuperscript{271} Thus, any such enforcement actions need real tethers to the disclosure realm and the role of the board to be legitimate.\textsuperscript{272}

In response to increased SEC scrutiny, directors should consider their options for protecting themselves from liability or sanctions. The most obvious response by directors is simply to increase and document their diligence. Recent corporate law cases make clear that directors need to improve corporate minutes for various reasons. Potential securities liability is an additional one. Directors can also rely on their peers when their

\textsuperscript{268} Former WorldCom directors Gordon Macklin, Lawrence Tucker, and Bert Roberts still serve as directors for public companies. Macklin is a director of Martek Biosciences Corp., MedImmune Inc, Overstock.com Inc, and several Franklin Templeton funds. Tucker is a director of National Healthcare Corp., and Trinsic Inc. and Roberts is a director of Valence Technology. See Maya Rooney, \textit{Teflon Directors}, \texttt{FORBES.COM}, Nov. 11, 2005, http://www.forbes.com/2005/11/16/corporate-boards-directors_cx_mr_1117directors_2.html (listing the former directors of troubled companies, such as WorldCom and Global Crossing, and current public company board memberships).


\textsuperscript{270} See, e.g., \textit{New Pressures Forge Stronger Board, CEO Ties}, AGENDA 1 (Jan. 23, 2006) (noting that boards are being pressured “to rigorously challenge management,” and that the result has been improved communications, content at meetings, information, and, generally, better relationships between board and CEO and increased focus on strategy and decision-making for shareholders).


\textsuperscript{272} See id. at 465-470.
reliance is based on sufficient diligence. In the past, the SEC has urged boards to consider creating disclosure committees charged with vetting and monitoring disclosures. In this, more aggressive, enforcement age, directors should consider whether such a committee might make sense. Again, the committee could provide protection for the rest of the board in a manner similar to the audit committee. And, in general, boards should determine whether disclosure controls are appropriate and in what circumstances. Presumably, such actions are likely to receive favorable attention from the SEC.

As the preceding discussion makes clear, the SEC intends to increase its focus on independent directors. This renewed commitment is consistent with the SEC’s stated policy goals and those of the securities laws. As the Commission stated in its release on due diligence, directors occupy a unique vantage point from which to evaluate disclosures and ensure appropriate due-diligence levels before statements are issued. They receive and review company information and filings and participate in the company business decision making. They are not, of course, day-to-day managers or monitors of the company. They are, however, the prescribed monitors of the key officers and insiders and monitors of the company’s disclosure process and results. The SEC’s renewed focus means that independent directors will need to revitalize their securities monitoring role.

273 SEC Release No. 6335, supra Note 239.
274 Id. at *12.