Corporate Financial Records and Internal Accounting Controls: What Does SEC Expect of Audit Committee Members

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I. Introduction

The potential liability of outside directors of publicly held corporations has expanded dramatically since the late 1960's, largely as a result of several important cases decided under the federal securities laws. During that time, the Securities and Exchange Commission (hereinafter "SEC" or "Commission") has become more and more concerned with corporate governance, and particularly with the role of the outside director, which the Commission believes is crucial to an effective corporate structure.

Increasingly, the Commission has sought the aid of outside directors in its efforts to protect investors. Toward that end, it has strongly supported the creation of audit committees which are composed entirely of outside directors. According to the Commission, "effective audit com-

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1 The term "outside director" is used in this comment to denote nonmanagement directors, i.e. those directors who have no connection with corporate management. Courts may use "outside," "uninterested," or "independent" interchangeably when referring to nonmanagement directors.

2 See infra text accompanying notes 55-87.

3 The SEC is the federal agency responsible for the administration and enforcement of the federal securities laws. See generally I L. Loss, SECURITIES REGULATION 129 (2d ed. 1961).

4 Former SEC Commissioner Sommer has stated:

[During the early seventies deeper Commission concern with corporate governance became apparent. It has become increasingly clear that the Commission is no longer content with its traditional role of abstention from interference with corporate governance and is restlessly seeking to affect the manner in which corporations are governed, the relationships between their managements and shareholders, the constitution of their boards of directors, and the manner in which various parts of the corporate community conduct themselves ...]


5 See infra text accompanying notes 88-118.

6 See generally Caplin, Outside Directors and Their Responsibilities: A Program for the Exercise of Due Care, 1 J. CORP. LAW 71, 71-73 (1975).

7 The SEC first advocated the use of audit committees in its report on McKesson & Robbins in 1940, after the Commission's investigation disclosed that the audited financial statements of McKesson & Robbins, a drug company listed on the New York Stock Exchange,
mittees composed of independent directors are the best assurance that meaningful internal controls will be established and enforced.98 Moreover, in the view of a former Commission chairman, the heightened sense of public responsibility which independent audit committees introduce into corporate governance helps to insure that adequate attention will be given to those problems in which the public shareholders have the greatest interest.9 Indeed, the audit committee has become so well established10 that the SEC staff has warned that "any company which has chosen not to establish such a committee . . . should weigh carefully the costs of such a decision in terms of liability and loss of control against the reasons, if any, for not establishing an audit committee."11

Despite its outward support for the establishment of audit committees, however, the Commission has provided almost no guidance as to what it expects of audit committee members, either in terms of duties and responsibilities, or in terms of the level of care, knowledge and involvement required. Thus, an outside director serving on the audit committee of a large publicly-held corporation may well wonder how he or she would fare should the SEC find it necessary to investigate a problem in the company's financial records or internal accounting controls.12


9 See Ferrara & Goldfus, The Government and Corporate Governance: What it Hears and How it is Responding, in CORPORATE GOVERNANCE (Prac. Law Inst. 1979)(citing address by Chairman Williams to the Institute of Internal Auditors (June 19, 1978)).

10 Eighty-four and one-half percent of the companies analyzed in a proxy data monitoring program conducted by the staff of the SEC in 1980 had audit committees. STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, 96TH CONG., 2D SESS., SECURITIES AND EXCHANGE COMMISSION REPORT TO CONGRESS ON CORPORATE ACCOUNTABILITY, A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY 488 (Comm. Print 1980)[hereinafter cited as STAFF REPORT].

11 Id. at 583.

12 The SEC has the power to conduct investigations of possible securities laws violations.
This comment offers guidance to audit committee members who face the prospect of such an investigation. Its focus is not on the potential liability of committee members generally under state and federal law, but rather on the SEC's expectations, specifically with regard to the audit committee member's responsibility for the maintenance of corporate financial records and internal controls.

The discussion is divided into four parts. First, the tasks which the SEC believes audit committee members should perform, and the specific duties which it has assigned to audit committees in the past are identified. Second, the potential liability of committee members generally under the federal securities laws is summarized. Third, SEC administrative decisions and enforcement actions involving outside directors are examined in an attempt to ascertain the standard of care to which audit committee members will be held by the Commission. Finally, the SEC's interpretation of the accounting provisions of the Foreign Corrupt Practices Act of 1977 is considered, together with recent cases and administrative decisions under the Act, in order to determine what impact it has on audit committee liability in the eyes of the Commission.

II. SEC on the Functions of Audit Committees

In its July 5, 1978 "Report to Congress on the Accounting Profession and the Commission's Oversight Role," the SEC set forth the following functions which it believes an effective audit committee should perform:

1. engage and discharge the auditors;
2. review the engagement of the auditors, including the fee, scope and timing of the audit and other services rendered;
3. review with the auditors and management company policies and procedures with respect to internal auditing, accounting and financial controls;
4. review with the independent auditors their report, their perception of the company's financial and accounting personnel, the


13 This comment is concerned only with the duties and responsibilities of audit committee members and the standard of care to which they may be held by the SEC. For an overview of the Commission's enforcement program and some insight as to how most effectively to represent clients under SEC investigation, see Brodsky, Representing Clients in SEC Investigations, 56 FLA. BAR J. 345 (April 1981). For a more detailed treatment of the process and the issues which are likely to arise, see Mathews, Litigation and Settlement of SEC Administrative and Enforcement Proceedings, 29 CATHOLIC U. L. REV. 215 (1980).

14 See infra text accompanying notes 46-54.


16 SECURITIES AND EXCHANGE COMMISSION, 95TH CONG., 2D SESS., SECURITIES AND EXCHANGE COMMISSION REPORT TO CONGRESS ON THE ACCOUNTING PROFESSION AND THE COMMISSION'S OVERSIGHT ROLE (Comm. Print 1978)[hereinafter cited as COMMISSION'S OVERSIGHT ROLE].
cooperation they received during the audit, the extent to which company resources were and should be utilized to minimize the time spent on the audit, any significant transactions which were unusual, any change in accounting principles or practices, all significant proposed adjustments and any suggestions they may have for improving internal accounting controls, choice of accounting principles, or management systems;

5. periodically review the company's code of conduct and investigate deviations from the policies therein;

6. meet with the company's financial staff at least twice a year to review internal accounting and audit procedures and the extent to which recommendations made by employees or by the independent auditors have been implemented; and

7. review significant press releases concerning financial matters.\footnote{Less than two weeks after the SEC issued its July 5th report, it proposed an amendment to the proxy rules which would have indirectly specified the duties which audit committees would be required to perform.\footnote{See SEC Exchange Act Rel. No. 14970, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,645 at 80,580 (July 18, 1978).} Although the proposed amendment did not require issuers to discuss the functions of their audit committees, a note to the amendment indicated the Commission's view that a statement that the company has an audit committee connotes that the committee performs at least the functions "customarily performed" by such a committee.\footnote{Id.} The "customary" functions of the audit committee, set forth by the Commission in the note, included engaging and discharging the independent auditors, directing and supervising special investigations, reviewing with the independent auditors the plan and results of the audit, reviewing the scope and results of the company's internal auditing procedures, approving all professional services provided by the independent auditors prior to the performance of the services, reviewing the independence of the independent auditors, considering the range of audit and non-audit fees, and reviewing the adequacy of the company's internal accounting control system.\footnote{Id.} Although the Commission made it clear that the note set forth only some of the functions which it believed effective audit committees should assume,\footnote{Id. at n.21. According to the Commission, it refrained from setting forth a more exhaustive list of functions in recognition of the fact that "the concept of the audit committee, its characteristics, and the functions it ought to perform are currently developing in an evolutionary manner." Id.} the note itself would have required issuers with audit committees that did not perform any one or more of the "customary" functions to identify those functions not performed.\footnote{SEC Exchange Act Rel. No. 14970, supra note 18, at 80,580. The Commission later...} This proposal generated
considerable negative reaction, leading the Commission to conclude that a rule containing a "compendium" of customary audit committee functions was inappropriate. It remained concerned, however, that disclosure of the existence of an audit committee would be meaningless without some indication of the functions which the committee performed. Thus, the amendment as adopted was revised to require a brief description of the functions actually performed by the audit committees.

The Commission backed down from its proposed negative disclosure requirement on audit committee functions partly out of fear that defining the customary functions of such committees would inhibit their evolution. It is interesting to note in this regard that the "customary" functions of audit committees contained in the proposed amendment were narrower in scope than the functions which the Commission believed an effective audit committee should perform, as enumerated in its report to Congress only two weeks earlier. Although the Commission was at first willing to trade a dampening effect on audit committee evolution for the certainty of the minimum required functions in the proposed amendment, it later changed its mind, apparently in the hope that audit committees would voluntarily perform the broader array of functions listed in the Commission's report to Congress. As a practical matter, therefore, audit committee members who are concerned about the possibility of an SEC investigation may rest easier if the committee on which they serve performs at least some of the broader functions listed in the Commission report.

With the stated purpose of "contributing to the ongoing evolution of audit committee responsibilities, the Commission instructed its Division of Corporate Finance to monitor proxy disclosures made in response to the amendment as adopted. The results of the proxy monitoring program were made public in a 1980 report to Congress. See STAFF REPORT, supra note 10.

Functions which the Commission believes an effective audit committee should perform, but which were not listed among the "customary" functions in the proposed amendment, include:

1. post-audit review of the company's financial and accounting personnel, significant unusual transactions, changes in accounting principles or practices, significant proposed adjustments and the choice of accounting principles or management systems;
2. review deviations from the company's code of conduct;
3. meet with the company's financial staff to review accounting and auditing procedures; and
4. review significant press releases concerning financial matters.

committee functions," and also, perhaps, in an effort to satisfy itself that the voluntary evolution of committee functions would in fact take place, the Commission instructed its Division of Corporate Finance to monitor the disclosures required by the new amendment to the proxy rules regarding the functions which audit committees were performing.

After monitoring the information disclosed and surveying the commentators, the staff of the Division of Corporate Finance identified the following functions of audit committees in a 1980 report to Congress:

1. Selection of the Independent Auditor. The staff noted that participation in the selection of outside auditors has been called "the closest thing to a universal function for all audit committees." Furthermore, audit committees had an important role to play in assuring the independence of the outside auditors. The staff observed that commentators, as well as the Commission, had suggested that "[t]he audit committee must control all services performed and the fees received by the auditors to insure that they are truly independent of management."

2. Review of Plan of Audit. The staff called this function "particularly important" because it is at this stage that the audit committee must assure itself that the audit will be adequate, and that it will satisfy the requirements of the board as well as those of management.

3. Review of Results of Audit. This is called "one of the most important" functions of the audit committee because it is at this point, if not earlier, that the committee becomes aware of differences of opinion between accountants and management. The staff stated:

   To carry out its responsibility the typical audit committee — even if it does little else — needs to satisfy itself that reported financial statements are accurate, complete and not misleading . . . . To gain insight into the auditors' relationship with management, special consideration might be given to areas where management and the auditors disagreed and how those differences were resolved.

29 SEC Exchange Act Rel. No. 15384, supra note 22, at 81,095 n.18.
30 Id. The amendment, as adopted, is now Item 6(d)(1) of Schedule 14A, 17 C.F.R. § 240.14a-101 (1983).
31 See STAFF REPORT, supra note 10, at 496-506.
32 Id. at 497 (citing J. BACON, CORPORATE DIRECTORSHIP PRACTICES: THE AUDIT COMMITTEE 14 (Conf. Bd. 1979)).
34 STAFF REPORT, supra note 10, at 499.
35 Id. at 500 (citing J. BACON, supra note 32, at 22; Greene & Falk, supra note 33, at 1241).
Commentators have also suggested that audit committees review the quality and depth of staffing in the company's accounting and financial departments.  

4. Review of Internal Controls. According to the staff, this function is becoming even more important since passage of the Foreign Corrupt Practices Act. 

5. Review of Interim Financial Information. The staff noted that some commentators had suggested the importance of this function, while others have expressed uncertainty due to the limited scope of the interim review and the little time available between preparation of the statements and their publication.

6. Review of Press Releases. To the extent that the audit committee is viewed as the overseer of the reporting of financial information by the company, the staff had previously stated that the audit committee should review interim financial statements and other significant press releases concerning financial information prior to publication.

7. Special Investigations.

8. Internal Audit Function. The staff noted that commentators had suggested that the audit committee review the internal audit function just as it would review the independent audit. The committee should meet with the internal audit staff and review its systems and procedures, as well as the results of its internal audits. "Essentially, audit committees are looking for indications of serious trouble when they review internal audit results. They hope to catch potentially significant problems or deficiencies in time to deal with them before damage is done."

9. Review of Codes of Conduct. The staff noted that it had been suggested that the audit committee establish and review the corporation's code of conduct to insure employee compliance with the corporation's standards of ethical conduct.

10. Providing Information to the Board.

According to the staff, the above functions are "illustrative of the functions that boards of directors may consider in determining the responsibilities of their audit committees." The staff noted that while the list may change with the circumstances, certain functions, such as engagement of the independent auditors and review of the scope and result of the audit, are probably so basic that they generally should be per-

37 STAFF REPORT, supra note 10, at 502.
38 Id. at 503 (citing COMMISSION'S OVERSIGHT ROLE, supra note 16).
39 Id. at 503 (citing COMMISSION'S OVERSIGHT ROLE, supra note 16).
40 STAFF REPORT, supra note 10, at 505 (quoting J. BACON, supra note 32, at 34).
41 STAFF REPORT, supra note 10, at 508.
42 Id.
formed by every audit committee. In any event, it was "essential" that committee members be given sufficient authority and specificity as to their responsibility. In the staff's view, the increasing popularity of committee charters as a tool for defining audit committee responsibilities was a favorable development.

In addition to the above statements on the functions of audit committees, the Commission has laid down directives on the duties of audit committees in several consent decrees in which defendants have agreed to establish such committees. For example, in *SEC v. Killearn Properties, Inc.*, the company was ordered to establish an audit committee which would have the following responsibilities:

i. It should review the engagement of the independent accountants, including the scope and general extent of their review, the audit procedures which will be utilized, and the compensation to be paid.

ii. It should review with the independent accountants, and with the company's chief financial officer (as well as with other appropriate company personnel) the general policies and procedures utilized by the company with respect to internal auditing, accounting and financial controls. The members of the committee should have at least general

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43 *Id.*
44 *Id.* at 496.
45 *Id.* at 483-84.
46 Consent decrees as a method of concluding litigation are viewed as a necessity for the Commission, which has neither the time nor the resources to litigate each case. They are also a speedy and efficient means by which to secure the immediate cessation of illegal conduct and to impose the desired relief. For the targets of the proceeding, there are many reasons to agree to a settlement. Early settlements limit the extent of adverse publicity, avoid more detailed elaboration of the proof underlying the charge (which would be presented, for example, in support of a preliminary injunction), may provide the opportunity to negotiate who is named in the injunctive decree, and preclude any possible collateral estoppel effects of the proceeding in future private actions. Additionally, because an unsuccessful defense is not reimbursable from corporate funds, the targets have an incentive to avoid costly litigation.

Although the decision to enter into a consent decree is an administrative act, the entry of the decree itself is an exercise of judicial power. By approving the consent judgment, the court is adjudicating the plaintiff's right to relief and its extent, both of which are essential elements of any judgment. The court must be satisfied that the decree is equitable, that it affords relief in the public interest, and that the violation will, in fact, be remedied. Once there is consent to a decree, it can be attacked on appeal only on the grounds of fraud, lack of actual consent, or lack of subject matter jurisdiction in the court entering the decree. That a remedy could not be imposed if the case were litigated is not ground for appeal. Finally, it is extremely difficult for the defendant to secure modification of the decree once it is entered.


familiarity with the accounting and reporting principles and practices applied by the company in preparing its financial statements.

iii. It should review with the independent accountants, upon completion of their audit, (a) any report or opinion proposed to be rendered in connection therewith; (b) the independent accountant's perceptions of the company's financial and accounting personnel; (c) the cooperation which the independent accountants received during the course of their review; (d) the extent to which the resources of the company were and should be utilized to minimize time spent by the outside auditors; (e) any significant transactions which are not a normal part of the company's business; (f) any change in accounting principles; (g) all significant adjustments proposed by the auditor; (h) any recommendations which the independent accountants may have with respect to improving internal financial controls, choice of accounting principles, or management reporting systems.

iv. It should inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct of the company and periodically review such policies.

v. It should meet with the company's financial staff at least twice a year to review and discuss with them the scope of internal accounting and auditing procedures then in effect; and the extent to which recommendations made by the internal staff or by the independent accountants have been implemented.

vi. It should prepare and present to the company's board of directors a report summarizing its recommendation with respect to the retention (or discharge) of the independent accountants for the ensuing year.

vii. It should have the power to direct and supervise an investigation into any matter brought to its attention within the scope of its duties (including the power to retain outside counsel in connection with any such investigation).

In addition, the Audit Committee shall be given the following special duties, functions and responsibilities:

viii. review, either by the Committee as a whole or by a designated member, all releases and other information to be disseminated by Killearn to press media, the public, or shareholders of Killearn which concern disclosure of financial conditions of and projections of financial conditions of Killearn and its subsidiaries;

ix. review of the activities of the officers and directors of Killearn as to their future dealing with the company and take any action the Committee may deem appropriate with regard to such activities;

x. approve any settlement or disposition of any claims or actions from causes of action arising after the date hereof or any litigation now pending which Killearn may have against any past or present officers, directors, employees or controlling persons.49

The list of audit committee functions in *Killearn* is the most extensive the Commission has ever caused a court to set forth in a consent decree. As a settlement, however, it is binding only on the defendant.50 Furthermore, the relief requested by the Commission in *Killearn* was re-

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49 *Id.* at 92,695.

50 Moreover, since most of the SEC's cases conclude with settlements, it is unclear whether a court, in a contested case, would find that the relief the Commission has been securing
medial. It is uncertain whether the SEC would insist upon such an extensive list as a prophylactic measure. Nevertheless, as one former SEC Commissioner has stated, *Killearn* does provide "significant insights into the Commission's conception of audit committee duties in general." Indeed, the audit committee functions listed in the Commission's July 1978 report to Congress appear to have been taken nearly word for word from *Killearn*, lending strong support to the argument that the Commission fully expects audit committees to perform more than the minimum "customary" functions.

III. Committee Member Liability Generally Under the Federal Securities Laws

The standard of liability for audit committee members as such under the Federal Securities laws has never been considered by a court, either with regard to recordkeeping, accounting controls or otherwise. As a general rule, however, outside directors who are more deeply involved in the activities giving rise to the litigation, or who have more knowledge and expertise than other outside directors, will be held to a higher standard of care than other outside directors. Although the standard varies somewhat with the statute at issue, directors who serve on a committee of the board may expect to be held to a higher standard of care with respect to matters within the scope of their committee's duties than outside directors who are not members of that committee.

through settlements is appropriate. Sommer, *supra* note 4, at 129. This comment is concerned only with the SEC's standards; not with the enforceability of those standards.

Even in the remedial context the Commission rarely enumerates the entire list of functions which it might expect the audit committee to perform. Instead, it focuses on the weakness or wrongdoing which has been discovered and tailors its relief to the specific problem it seeks to remedy. For example, in *SEC v. Marlene Industries Corp.*, 17 SEC DOCKET 406 (Lit. Rel. 8733) (S.D.N.Y. April 26, 1979), a case involving the payment of undisclosed benefits to corporate officers, the audit committee was ordered only to adopt internal control guidelines for the authorization and disbursement of funds. Similarly, in *In the Matter of Hycel, Inc.*, SEC Exchange Act Rel. No. 14981 [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,676 (July 20, 1978), the audit committee's sole specifically enumerated function was to make a periodic review of the company's compliance with written corporate policies governing personal charges and travel and entertainment expenses. *Id.* at 80,731.

Sommer, *supra* note 4, at 132-33.

*See Commission's Oversight Role, supra* note 16.

*Compare id. at 99-100 with [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,256 at 92,695.

*See, e.g., Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). There is little question that the SEC attempts to hold outside directors to a higher standard of care than do the courts. This comment merely summarizes some of the more important cases in order to provide a basis for comparison with the Commission's views which are discussed *infra*. See text accompanying notes 88-118. For a more detailed discussion of the standard of care applied to outside directors under the federal securities laws generally, see Note, *supra* note 4, at 363-87; Goldstein & Shepard, *Directors Duties and Liabilities Under the Securities Acts and Corporation Law*, 36 WASH. & LEE L. REV. 759, 763-73 (1979).

*See Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. Onandoga Cty 1966)(applying state law). Although no other recent cases were found in which the standard of care for committee members was discussed, the rule expressed in *Syracuse Television* follows logically from the general rule expressed in *BarChris*, 283 F.
In *Escott v. BarChris Construction Corp.*, the first important modern federal case to consider the standard of liability for outside directors under the securities laws, the Federal District Court for the Southern District of New York rejected the "due diligence" defenses of three outside directors who had been charged with violating Section 11 of the 1933 Act. The court found that all three of the outside directors had failed to use reasonable care to investigate the facts and had relied too heavily on the company's management and independent auditors. One outside director, an attorney who was involved in the actual drafting of the registration statement, was held to an even higher standard. According to the court, "[a]s the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work."

The duty of the outside director-attorney in *BarChris* can accurately be described as a duty to discover. The court acknowledged that "[t]o require an audit would obviously be unreasonable," but in this case the court felt there were errors and omissions which could have been uncovered without an audit. "The question is whether, despite his failure to detect them, [the outside director-attorney] made a reasonable effort to that end." The court concluded that even if the outside director-attorney had been deliberately misled by BarChris's officers and had honestly believed that the registration statement at issue was accurate, he "failed to make an inquiry which he could easily have made which, if pursued, would have put him on his guard."

First, with regard to the duty to investigate, the reasonableness of the investigation should depend on the outside director's access to information. For example, participants in the drafting of a registration statement clearly have access to more information than do nonparticipants; thus, a "reasonable investigation" by a participant director must be more extensive. Second, once the duty to investigate is met, the quality of the investigation must be measured to determine whether the outside direc-

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58 Section 11 of the Securities Act of 1933 provides a cause of action against directors of an issuer (among others) on behalf of purchasers of the issuer's securities who relied on any untrue statement or omission of a material fact in the registration statement. See 15 U.S.C. § 77k(a). The principal defense available to directors under § 11 is that they exercised "due diligence," as defined in the statute, in meeting the registration requirements. See 15 U.S.C. § 77k(b)(3).
59 283 F. Supp. at 690.
60 Id.
61 Id.
62 Id. at 692.
63 See Note, supra note 4, at 470-71.
tor discovered what he should have discovered given the information he obtained.64

Technically, the standard of care imposed in BarChris applies only to suits brought under Section 11 of the 1933 Act, and audit committee members can take comfort in former Commissioner Sommer's observation that the case "imposes an excessively strict obligation on the outside directors."65 Nevertheless, the reasoning the court used to impose a higher standard of care on the outside director-attorney would apply outside the Section 11 context. Audit committee members clearly have access to more information regarding the corporate books, records, and internal controls than do noncommittee members; thus, a "reasonable investigation" of such matters by an audit committee member must be more extensive than a similar investigation conducted by other outside directors.

In Lanza v. Drexel,66 a landmark case involving the liability of outside directors under Section 10(b) and Rule 10b-5 of the 1934 Act,67 the Second Circuit held that an outside director who had not participated in any purchase negotiations owed no affirmative duty to investigate or ascertain whether all material adverse information about his company was disclosed to prospective stock purchasers.68 According to the Lanza court, the outside director's liability, if any, must be that of an aider and abettor, a conspirator, or a substantial participant in the fraud perpetrated by others.69 Thus, the outside director had only an obligation to avoid a "willful or reckless disregard for the truth."70 In the court's view, this meant that the outside director must not know of the misstatements or omissions, or fail or refuse to investigate when "put on notice," if such investigation can be undertaken "without an extraordinary effort."71

The Lanza court believed that the proper role of the outside director was to supervise management's performance, which necessitated "balancing skepticism towards management's assessment of its performance with trust in its integrity and competence."72 As the SEC stated in its amicus brief:

Corporate directors are not normally involved in the day-to-day

64 Id.
66 479 F.2d 1277 (2d Cir. 1977).
67 Section 10(b) is the general antifraud provision of the Securities Exchange Act of 1934. See 15 U.S.C. § 78j(b). Rule 10b-5 makes it unlawful (a) to employ any device, scheme or artifice to defraud, (b) to make untrue statements or omissions of material facts, and (c) to engage in any act or practice which would operate as a fraud or deceit in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (1983).
68 479 F.2d at 1289.
69 Id.
70 Id. at 1306.
71 Id. at 1306 n.98.
72 Id. at 1306.
conducted of the company's affairs. Except in unusual circumstances, they are not expected to, nor do they, participate directly in the implementation of corporate policies. Routine managerial tasks are performed by, and are the responsibility of, the operating officers. Directors have a right to rely on the officers of the corporation to perform their functions in a lawful manner.73

If the standard of care imposed on the outside director in *Lanza* is less strict than that imposed in *BarChris*, it may be explained in part by the fact that *Lanza* involved negotiations carried out by management, while the registration statement in *BarChris* was issued by the board of directors.74 Moreover, the outside director in *Lanza* was uninvolved in the negotiations, and thus without access to information which would have put him on notice of the need to further investigate.75

The *Lanza* rationale was followed in *Hamilton Bank and Trust Co. v. Holliday*,76 which involved alleged violations of several provisions of the 1933 and 1934 Acts, including Section 10(b) and Rule 10b-5. The *Hamilton* court stated that as a practical matter it was unrealistic to require outside directors to investigate the corporation's incidental securities transactions77 which were carried on or participated in by the corporation's officers without the directors' actual knowledge or participation.78 According to the court, an outside director is chargeable only with the degree of knowledge which the corporate books and records and the directors meetings would fairly disclose.79 Directors are entitled to rely on the corporation's officers, and are “not required to presume rascality, maintain a constant vigilance over the corporation's business transactions, or assume the responsibilities of the corporation's managing officers.”80

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73 Id.
74 See Note, supra note 4, at 377.
75 Id. Any further differences between the standards imposed in the two cases are most likely explained by the fact that they arose under different sections of the securities laws. Id. at 377-78. See also Gould v. American Hawaiian Steamship Co., 351 F. Supp. 853 (D. Del. 1972) (negligence is the standard for liability under Section 14(a) of the 1934 Act).
77 Id. at 1242. The securities in question were sold by a subsidiary of the company on whose board the outside directors sat. Id.
78 Id.
79 Id.
80 Id. (quoting Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). See also Decker v. Massey-Ferguson, Ltd., 681 F.2d 111 (2d Cir. 1982)(no duty imposed on outside director [under § 10(b)] to insure that all material adverse information about the corporation was conveyed to prospective purchasers); In re Investors Funding Corp Securities Litigation, Bloor v. Dansker, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,238 at 96,031 (S.D.N.Y. 1983) (“Although the responsibilities imposed upon outside directors . . . are not stringent, it is clear that . . . they should supervise the performance of management. Thus, any management malfeasance was a direct, and not an unforeseeable, consequence of the directors' neglect of their directorial responsibilities,” but scienter is a necessary element of the § 10(b) claim); Greene v. Emersons, Ltd., 86 F.R.D. 66, 72-73 (S.D.N.Y. 1980)(outside director's failure to discover the improprieties of a corporation's officers, even if such behavior could be characterized as "reckless," does not constitute scienter which, under those circumstances, requires something closer to actual intent to defraud).
 Holliday, like Lanza, does not affect the BarChris principle that the more involved an outside director is, the higher his standard of care. Both Holliday and Lanza simply held uninvolved outside directors to a lower standard than did BarChris. The uninvolved outside directors in Lanza were held responsible only for those developments which came to their attention, and then only to the extent that any investigation could be accomplished without "extraordinary effort." Similarly, in Holliday, the outside directors were expected to know only what the corporate books and records and the directors meetings would "fairly disclose." In BarChris, on the other hand, even the uninvolved outside directors were charged with an affirmative duty to investigate the facts.

As previously mentioned, the difference between the strict standard imposed in BarChris and the lower standard of Lanza and Holliday may well be attributable to the difference between the statutory sections under which the cases were brought. Whatever the standard of care imposed on uninvolved outside directors, however, BarChris stands for the proposition that the standard for involved outside directors will be higher. An audit committee member who does not actually participate in activities which affect corporate books, records or internal controls may find himself in the unique position of being less involved than an outsider, yet more involved than other outside directors, simply by virtue of his committee membership.

IV. SEC Reports, Enforcement Actions and Administrative Proceedings

A former SEC Commissioner has commented with regard to proposed guidelines for corporate directors, that "although contributions to clarity and certainty can be made with respect to such concepts as 'mate-

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81 479 F.2d at 1306 n.98.
82 469 F. Supp. at 1242.
83 283 F. Supp. at 688-89.
84 See supra note 75.
85 BarChris involved § 11 of the 1933 Act, which imposes strict liability on directors. See supra note 58. Lanza involved § 10(b) of the 1934 Act, see supra note 67, which the Lanza court interpreted to require "willful or reckless disregard for the truth . . . ." 479 F.2d at 1306. The United States Supreme Court has since determined that scienter is required under § 10(b). See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).
86 See supra text accompanying notes 57-65.
87 The existence of an Audit Committee may lead, in effect, to three different standards of liability. At one extreme, inside directors will be held as always to the highest standard of liability. At the other extreme, outside directors who do not serve on an Audit Committee will continue to be subject to a lower standard of liability. By virtue of the knowledge of corporate affairs which they acquire, or are expected to acquire, as a result of their membership on the Audit Committee, outside directors serving on the Committee may be held to a higher standard than outside directors not serving on the Committee; but the standard of Committee members will probably be lower than that of the inside directors who, because of their day-to-day involvement with the operations of the company, have even greater knowledge of corporate affairs.

Green & Falk, supra note 33, at 1247-48.
rilality’ and a director’s ‘due care,’ such concepts cannot be reduced to a rule of mathematical precision without doing more harm than good. Implicit in this statement is the realization that a director’s duty of care in any given situation depends on the circumstances of the particular case. Unfortunately, the SEC has never focused on the standard of care for audit committee members as such in any of its reports, enforcement actions or administrative proceedings. Some useful guidelines have emerged, however, from the few cases in which the Commission has considered the outside director’s duties and liabilities.

The Commission’s investigation and Report to Congress on the Financial Collapse of the Penn Central Company has been called a “turning point” in the SEC’s policy on the role of directors. According to the staff report, the directors of Penn Central were accustomed to a “generally inactive” role in their respective positions as directors of the Pennsylvania and New York Central Railroads. They relied on oral descriptions of company affairs both before and after the merger of the two companies which formed Penn Central, and failed to fully comprehend the details of the merger, or the fact that it had not been adequately planned. Moreover, they did not demand or receive information which was essential to understanding the company’s position or management performance, and had deliberately avoided confrontations with management on issues critical to testing the integrity of management and providing adequate disclosure to shareholders. The staff concluded that a proper inquiry would have uncovered improprieties and the “concomitant need to provide full and adequate disclosure . . . .” Instead, the directors had permitted management to run the business without any effective review or control and had remained uninformed throughout the entire series of important events.

According to the SEC staff, the Penn Central Board had failed in two principal ways; it had failed to establish procedures, including a flow of adequate financial information, to allow the directors to understand what was happening and to enable them to exercise control over management’s conduct, and it had “failed to respond to specific warnings about the true condition of the company and about the questionable

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89 STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, 92D CONG., 2D SESS., SECURITIES AND EXCHANGE COMMISSION REPORT TO CONGRESS ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Comm. Print 1972) [hereinafter cited as PENN CENTRAL REPORT].
92 Id.
93 Id. at 82,012-013.
94 Id. at 82,013.
conduct of the most important officers. As a result, Penn Central's investors had been deprived of adequate information about the condition of the company.

There is no evidence in the *Penn Central* report to indicate that Penn Central's outside directors had been deliberately deceived by the company's officers and inside directors. Rather, in the face of the dramatic change in the complexity of corporate matters as a result of the merger and diversification efforts, the board had simply failed to effectively monitor the company's management. Presumably, the "specific warnings" to which the staff refers are the numerous indications of critical operating and financial problems surrounding the merger which must have reached the outside directors despite their inactive role. Also, the directors had been made aware of a lawsuit alleging improper and unlawful conduct on the part of the chief financial officer of Penn Central.

The *Penn Central* report indicated that outside directors have an affirmative duty to establish procedures to ensure that they receive adequate financial information. In addition, the standard of care to which outside directors would be held, and presumably the amount of information which might be considered "adequate," changed with the circumstances. Dramatic changes or times of stress in the company's existence required particular vigilance on the part of the outside directors, while business as usual required less active involvement. Under no circumstances, however, were the outside directors entitled to rely completely on management. The only question was how much affirmative action was required.

Not all of the actions taken by the Commission involving outside directors have involved wrongdoing as obvious as that in the *Penn Central* report. In *Report of the Investigation in the Matter of Sterling Homex Corp.*, for example, the Commission noted that Sterling Homex's outside directors had been deliberately deceived by management. Despite the deliberate deception, however, each of the outside directors possessed considerable business experience and sophistication, and, according to the Commission, should have played a more significant role in the company's affairs. Instead, board meetings had been perfunctory and conducted without a written agenda; in fact, they were often conducted by telephone, and rarely included discussion or interrogation of management. No committees were formed to help the board perform its responsibilities, or to receive, solicit, or evaluate information from management. The outside directors were not given, and never obtained, timely, accurate or complete information with respect to such matters as backlogs,

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95 *Penn Central Report*, *supra* note 89, at 287.
96 *Id.*
97 *Id.* at xiii.
99 *Id.* at 85,462.
aging of receivables, cash flow needs, or problems relating to completion of contracts. As a result, they "could not and did not make probing inquiries regarding those matters."100

Sterling Homex's directors relied on the fact that the company's independent accountants had accepted the company's accounting practices as being in conformance with generally accepted principles. Thus, they made no significant effort to analyze or familiarize themselves generally with the accounting practices, which led, in the Commission's view, to their failure to understand the implications of those practices and their susceptibility to abuse.101

Beyond the somewhat vague statement that an outside director must obtain a sufficient grasp of the business and accounting practices to enable him to make "informed judgments," there is no indication in the Sterling Homex report of exactly how much knowledge the Commission expects outside directors to possess. It is safe to assume, however, that if outside directors are expected to make "probing inquiries" into such matters as backlogs, aging of receivables, and cash flow needs, they must have at least a basic understanding of accounting and business practices.102

Another question left unanswered by the Sterling Homex report is the extent to which outside directors may rely on the independent auditors. According to the Commission, the outside directors' reliance in this case was "understandable," but it was apparently not acceptable to the extent that it led the outside directors to make to no "significant effort" to familiarize themselves with the accounting practices being used. Presumably, had the Sterling Homex directors been knowledgeable with regard to the practices employed by the accountants, they would at least have been aware of the need for greater scrutiny.

It is clear from the Penn Central and Sterling Homex reports that the SEC expects outside directors to play an active role; especially during critical moments in the company's existence.103 The Commission

100 Id. at 85,461.
101 Id. at 85,462-463.
102 In SEC v. Killearn Properties, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,256 (N.D. Fla. 1977), the Commission stated that the members of an audit committee which Killearn had agreed to establish as part of a consent decree should have "at least general familiarity with the accounting and reporting principles and practices applied by the company in preparing its financial statements." Id. at 92,695.
103 Many of the major SEC reports, enforcement actions and administrative proceedings involving outside directors have also involved companies experiencing what could be called "critical" moments in their existence. In the Penn Central report, for example, the company had just completed a major reorganization and was facing imminent bankruptcy, see [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,931, while in the Sterling Homex report the company had recently been engaged in two public offerings and was also sliding toward bankruptcy. See [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219. See also In the Matter of National Telephone Co., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,410 (January 16, 1978)(company faced series of serious financial difficulties, eventually leading to bankruptcy); SEC v. Shiell, SEC Litigation Rel. No. 7763, 11 SEC DOCKET 10 (January 31, 1977)(company involved in public offering).
stressed, however, that its *Sterling Homex* report was not intended to pro-
mulgate guidelines with respect to the duties of outside directors.\(^{104}\) Rather, it simply illustrated a situation where outside 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 shareholders and others might reasonably have expected.”\(^{105}\)
Thus, the Commission viewed the concept of “reasonable expectations”
as critically important in determining the extent of an outside director’s
duties and liabilities.\(^{106}\) Undoubtedly, investors expect their outside di-
rectors to be informed, not to be mere figureheads; to ask pertinent,
probing questions, not simply to accept answers on blind faith. It follows
that although audit committee members have never been singled out in a
Commission report or proceeding, they are likely to be held to a very
high standard, at least as to matters within the scope of their responsi-
bility, where investors and others might reasonably expect them to be in-
formed and actively protecting the investors’ interests.

In *In the Matter of National Telephone Company*,\(^{107}\) the SEC concluded
that the outside directors had a duty to see to it that proper disclosures
were made when they were aware that the optimistic nature of the com-
pany’s public disclosures were in direct contrast with the true state of the
company’s affairs.\(^{108}\) The Commission stated expressly that it was “not
saying that the directors of a company are responsible for approving
every line of every press release and periodic filing made by the com-
pany.”\(^{109}\) Rather, during troubled times in the company’s existence, the
directors have an affirmative duty to assure that investors are provided
with accurate and full disclosures concerning the basic viability of the
company and its prospects for continuing operation.\(^{110}\)

The outside directors in *National Telephone* had taken no part in the
preparation of the misleading disclosures, but like the outside directors in
the *Penn Central* and *Sterling Homex* reports, they all had “extensive ex-
perience in financial and business matters” and should have been aware of
the need for corrective disclosure.\(^{111}\) Though aware of the facts, how-
ever, they took no meaningful steps to see that adequate disclosures were
made. No board meetings were held during a “most critical” time for
the company, and the outside directors did nothing effective to insure
that they were provided adequate, current information. In fact, the com-
pany’s audit committee, composed of three outside directors, never
met.\(^{112}\) The Commission concluded:


\(^{105}\) *Id.*

\(^{106}\) See Sporkin, supra note 90, at 457.


\(^{108}\) *Id.* at 88,878.

\(^{109}\) *Id.*

\(^{110}\) *Id.*

\(^{111}\) *Id.*

\(^{112}\) *Id.* at 88,880.
Outside directors should be expected to maintain a general familiarity with their company's communications with the public. In this way, they can compare such communications with what they know to be the facts, and if the facts as they know them are inconsistent, they can see to it, as stewards for the company, that appropriate revisions or additions be made.

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. [113]

Finally, in SEC v. Shiell, [114] the Commission expressed its view that the mere issuance of a prospectus signed by the directors constituted an implied representation that the directors were properly carrying out their functions. [115] According to the SEC, the outside directors of the mortgage banking and brokerage company had falsely represented that they were exercising proper control and authority over management, when in fact they had failed to exercise adequate control and had failed to inquire into business dealings when "they knew or should have known that the company's financial condition was worsening." [116]

The facts in Shiell were similar to those in the Sterling Homex report in that the officers of the company had deliberately concealed much of their conduct from the directors. Despite numerous danger signals and warnings, however, the directors had failed to take affirmative action to withdraw a public offering of common stock. Furthermore, although they had attended board meetings, and in fact received "voluminous" information about some areas of the company's business, the directors had failed to establish specific reporting requirements from management respecting "high risk" loans which constituted a significant part of the company's assets. [117] Instead, the Commission alleged, they placed "unwarranted reliance on the company's president . . . using him as their sole source of all information regarding company activities and operations, and accepting his reports at face value, without even questioning other officers." [118]

V. The Foreign Corrupt Practices Act

records and accounting controls.  Although it applies by its terms only to "issuers," and not to officers and directors, Section 13(b)(2) necessarily affects the standard of care to which audit committee members will be held. It provides as follows:

(2) Every issuer which has a class of securities registered pursuant to section [12] of this title and every issuer which is required to file reports pursuant to section [15(d)] of this title shall—

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—

(i) transactions are executed in accordance with management’s general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management’s general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Pursuant to the above statutory provisions, the SEC has adopted Regulation 13b-2, which does apply directly to audit committee members as directors. It provides as follows:

Rule 13b2-1. Falsification of Accounting Records

No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.

Rule 13b2-2. Issuer’s Representations in Connection with the Preparation of Required Reports and Documents

No director or officer of an issuer shall, directly or indirectly,

(a) make or cause to be made a materially false or misleading statement, or

(b) omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances under which such statements were made, not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer required to be made pursuant to this subpart or (2) the preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.


124 Id.
A. SEC Interpretation of Section 13(b)(2) and Regulation 13b-2

According to the SEC, the primary purpose of the FCPA accounting provisions was "to require those public companies which lacked effective internal controls or tolerated unreasonable recordkeeping to comply with the standards of their better managed peers." Thus, the Act's purpose is not to require business records and controls to conform to some absolute ideal, but rather to assure that the records of a public company "in reasonable detail, accurately and fairly reflect" disbursements of its assets, and that its internal accounting controls are "sufficient to provide reasonable assurances" that the provision's objectives will be met. Reasonableness, rather than materiality, is the test to be applied.

According to the Commission, there is an "almost infinite variety" of acceptable control devices available in a particular business environment. "Thus, considerable deference properly should be afforded to the company's . . . business judgments . . . " and so long as the choice and implementation of control procedures are reasonable under the circumstances, they remain management's prerogatives and responsibilities.

Under Section 13(b)(2), management and the board have a responsibility to foster integrity among those who operate the control system. In the Commission's view, it is not likely that control objectives will be met in the absence of a supportive environment, and the key to an adequate control environment is "an approach on the part of the board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished."

The Commission has stated that:

The Act's accounting provisions do not require a company or its senior officials to be the guarantors of the conduct of every company employee. A failure to correct a known falsification — or a falsification that reasonably should be known — or any attempt to cover-up a falsification — is, of course, prohibited. But this responsibility arises only when the individual in question is in some respect responsible for the records or controls, or otherwise supervises, the activity giving rise to the violation.

126 Id. (emphasis in original).
127 Id. at 17,233-9. See also SEC Exchange Act Rel. No. 15570, [1979 Transfer Binder] Fed. SEC. L. Rep. (CCH) ¶ 81,959 at 81,395 (February 15, 1979) ("[Section 13(b)(2)] may provide an independent basis for enforcement action by the Commission, whether or not violation of the provisions may lead, in a particular case, to the dissemination of materially false or misleading information to investors").
129 Id. (emphasis in original).
130 Id.
131 Id.
An adequate system of internal controls means that, when such breaches do arise they will be isolated, rather than systematic, and they will be subject to a reasonable likelihood of being uncovered in a timely manner and then remedied promptly. Barring, of course, the participation or complicity of senior company officials in the deed, when discovery and correction expeditiously follow, no failing in the company's internal controls would have existed. To the contrary, routine discovery and correction would evidence effective controls.  

Although the standards for compliance with Section 13(b)(2) are somewhat ambiguous, the SEC will not render prospective advice on the applicability of the FCPA to particular factual situations. The legislative history of the FCPA indicates, however, that Congress intended that attainable standards of reasonableness should be applied in the enforcement of the accounting requirements. In determining compliance with the recordkeeping requirements of subsection (A), the applicable standards are generally recognized accounting practices, and the body of accounting principles, standards and practices which have substantial authoritative support and are consistent with the SEC’s existing pronouncements regarding accounting requirements. The subsection (B) control requirements are taken almost word-for-word from the AICPA’s Statement on Auditing Standards No. 1.

To implement section 13(b)(2), the Commission adopted Rules 13b2-1 and 13b2-2, which are codified under Section 13 of the 1934 Act and based in part on a number of other disclosure-related provisions. Rule 13b2-1 is intended to "promote compliance with the statutory requirement that issuers have accurate books and records by discouraging persons from falsifying any corporate book, record, or account subject to . . . Section 13(b)(2)(A) and by making individuals [including officers and directors] directly liable for such conduct." According to

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132 Id. at 17,235.
135 Id.
136 AICPA Statement on Auditing Standards No. 1, § 320.28 (1973).
139 According to the Commission, Rules 13b2-1 and 13b2-2 are based in part on the following provisions:
(a) Sections 13(a), 13(b)(1) and 15(d) of the Act, which set forth certain periodic reporting requirements; (b) Section 10(b), which prohibits fraud; (c) Section 14(a), which governs proxy solicitations; (d) Section 20(b), which prohibits unlawful conduct performed by any person "through or by means of any other person"; and (e) Section 20(c), which prohibits any director or officer of, or any owner of securities issued by, any issuer required to file any document, report or information under . . . "the Securities Exchange Act without just cause to hinder, delay or obstruct the making of filing of any such document, report or information . . . ."
140 Id. at 81,396-97.
the Commission, there is no limitation concerning "material" falsity, and no scienter requirement, which the Commission believes would be inconsistent with the language of section 13(b)(2)(A). \(^{141}\) Rule 13b2-2 is primarily intended to restore the efficacy of the corporate accountability system and to encourage boards of directors to exercise their authority to deal with the problem. \(^{142}\) The Commission intends the rule to cover the audit of financial statements, the preparation of required or special reports to be filed with the Commission, "and any other work performed by an accountant that culminates in the filing of a document with the Commission." \(^{143}\) Although a materiality requirement is written into the rule, the Commission contends that there is no scienter requirement, again because it believes that a scienter requirement is inconsistent with the language of Section 13(b)(2). \(^{144}\)

Given the lack of any materiality or scienter requirement in Section 13(b)(2), and the Commission's view that scienter is not required to prove a violation of the rules, audit committee members have particular cause to be concerned. Section 13(b)(2) and the SEC's rules could be interpreted to cover violations of conduct codes, lack of supervision by management or the board, failure to follow internal policies and procedures and countless other areas which often directly concern audit committees. \(^{145}\) Indeed, the General Counsel of the SEC has stated that Section 13(b)(2) represents one of several possible grounds for mandating that all public companies maintain audit committees. \(^{146}\)

It should be remembered, however, that because Section 13(b)(2) applies only to "issuers," and not to officers and directors, audit committee members may be charged only with aiding and abetting an issuer's Section 13(b)(2) violation. Thus, as a practical matter, some form of scienter is likely to be required. \(^{147}\) Moreover, despite the Commission's be-

\(^{141}\) Id. at 81,397-98.
\(^{142}\) Id. at 81,399.
\(^{143}\) Id.
\(^{144}\) Id. at 81,400.
\(^{145}\) See Baker, supra note 121, at 841.
\(^{146}\) See Memorandum of SEC General Counsel, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535 at 80,181 (March 2, 1978).
\(^{147}\) A number of circuits have adopted a three-tier analysis set forth by the Sixth Circuit in SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975), to determine whether aider and abetter liability can be imposed. See, e.g., Cleary v. Perfectine, 700 F.2d 774 (1st Cir. 1983); Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982); ITT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Decker v. SEC, 631 F.2d 1380 (10th Cir. 1980); Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975). Under the Coffey test, the plaintiff must prove (1) that the primary party, as distinguished from the secondary aiding and abetting party, committed a securities law violation; (2) that the defendant had knowledge of the fraud; and (3) that the defendant rendered "substantial assistance" to the primary violation. 570 F.2d at 48. Thus, even if negligence is the appropriate standard for issuers in the context of § 13(b)(2), it would probably be insufficient to support a finding of aiding and abetting a § 13(b)(2) violation.

Inaction can be a form of assistance in certain cases, but only where it is shown that the silence of the accused aider and abetter was consciously intended to aid the securities law violation. See, e.g., Marbury Management, Inc., v. Kohn, 629 F.2d 705 (2d Cir. 1980) (brokerage firm could not be held liable as "aider and abetter" of its employee's fraudulent activities where
lief that Rule 13b2-1 lacks a scienter requirement, the words "falsify or cause to be falsified" strongly imply that something more than negligence might be required.148

B. SEC Enforcement Actions and Administrative Proceedings

To date, all of the cases brought under the FCPA accounting provisions have been brought by the SEC,149 and every action by the Commission has involved officers and inside directors in egregious factual circumstances where the misconduct was clearly knowing and intentional, or at the very least reckless.150 Moreover, the Commission has never brought a "pure" FCPA action, but has always tackled the Section 13(b)(2) violation onto numerous other substantive violations of the antifraud or reporting provisions of the 1934 Act.151

In SEC v. Animex Resources Corp.,152 the first suit brought by the SEC under the FCPA, the Commission alleged that Animex, a company engaged in coal mining and coal mine leasing, and its former officers, had misappropriated and diverted at least $1.24 million of corporate assets by engaging in a number of fraudulent practices, including payments to a bogus account, kickbacks, and unauthorized salary payments, and that they had disguised the misappropriations by means of false and improper accounting in the corporate books and records.153 The corporation, aided and abetted by its president, who was also the chief executive of-
ficer and a director, was charged with violating Subsections 13(b)(2)(A) and (B) because it had maintained false entries on the books and records, and had "failed to devise an adequate accounting control system," in part to further conceal the fraudulent activities.\footnote{Id. at 93,204.}

In \textit{SEC v. World-Wide Coin Investments, Ltd.},\footnote{[1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,214 (N.D. Ga. 1983).} the SEC sought a permanent injunction against World-Wide and several individuals including Hale, the company's president and chairman of the board, and Siebert, an employee of a World-Wide subsidiary who was also World-Wide's one-man "audit committee." The Commission alleged violations of Section 13(b)(2) and numerous other federal securities laws, resulting from a combination of late filings, lack of internal controls, transactions unsupported by adequate documentation, and a "total disregard for proper accounting procedures."\footnote{Id. at 95,862.}

World-Wide's independent auditor had written a letter to Hale expressing "grave concern" over certain accounting procedures and the lack of internal controls. Despite this official warning, however, nothing was done to remedy the situation. Instead, the auditor was replaced by new auditors who also found significant deficiencies in internal controls. Even when notified of a possible FCPA violation by a law firm hired at the suggestion of the new auditors, World-Wide did little to change its methods of operation. Nearly a year later, an SEC accountant concluded that there was still inadequate documentation to support purchases, and that internal controls remained inadequate.\footnote{Id. at 95,867.}

The court inferred the following directives from the internal controls provision of the FCPA:

1. Every company should have reliable personnel, which may require that some be bonded, and all should be supervised.  
2. Accounting functions should be segregated and procedures designed to prevent errors or irregularities. The major functions of recordkeeping, custodianship, authorization, and operation should be performed by different people to avoid the temptation for abuse of these incompatible functions.  
3. Reasonable assurances should be maintained that transactions are executed as authorized.  
4. Transactions should be properly recorded in the firm's accounting records to facilitate control, which would also require standardized procedures for making accounting entries. Exceptional entries should be investigated regularly.  
5. Access to assets of the company should be limited to authorized personnel.  
6. At reasonable intervals, there should be a comparison of the accounting records with the actual inventory of assets, which would usually involve the physical taking of inventory, the counting of cash, and the reconciliation of accounting records with the actual physical assets. Frequency of these comparisons will usually depend on the cost of the process and upon the materiality of the assets involved.\footnote{Id. at 95,875.}
According to the court, Congress was fully aware of cost-effective considerations, and has demanded only that judgment be exercised in applying the reasonableness standard. The size and nature of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and "numerous other circumstances" are factors which management must consider.\(^{159}\) The court noted what it called the "all pervasive effect" of the combined failure to act, failure to maintain adequate records, failure to maintain any type of inventory control, material omissions and misrepresentations, and other activities, and found that World-Wide, Hale, and Siebert had violated all the provisions of Section 13(b)(2)(A) and (B) and the SEC's rules promulgated thereunder.\(^{160}\)

It is clear that the Commission believes that proper recordkeeping and accounting controls are necessary, notwithstanding the FCPA, in order to comply with the other disclosure and reporting requirements of the Federal Securities Laws.\(^{161}\) For example, in *In the Matter of Martin E. Davis*,\(^{162}\) the Commission charged Davis, the chief financial officer of ISC Financial Corporation, and other officers and inside directors of the company with violating the antifraud and reporting provisions of the Exchange Act. The SEC alleged that the breakdown of Old Security’s internal controls prevented ISC and Davis from making accurate financial disclosure, and that Davis had participated in the company's filing of materially inadequate reports with the Commission.\(^{163}\)

Although the circumstances which gave rise to the SEC's order in *Davis* predated the enactment of the FCPA, the Commission indicated that the internal control deficiencies in question "would likely have constituted, in and of themselves, a violation of Section 13(b)(2)."\(^{164}\)

VI. Conclusion

Audit committee members occupy a unique position in the eyes of the SEC. Although, as outside directors, they are not expected to participate in the day-to-day management of the company, they are expected to be informed, and to play an active role in the business. Moreover, the Commission expects audit committees to perform a broad array of functions, and will attempt to hold committee members to a very high stan-

\(^{159}\) Id.

\(^{160}\) Id. at 95,876.


\(^{162}\) SEC Accounting Series Release No. 267, [Accounting Series Releases Transfer Binder] (CCH) ¶ 72,289 (July 2, 1979).

\(^{163}\) Id. at 62,749-75, 62,750.

\(^{164}\) Id. at 62,750 n.10. See also *In the Matter of Telex Corp.*, SEC Exchange Act Rel. No. 18694, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,209 at 85,057 n.7 (April 29, 1982) (appropriate documentation and control of corporate prerequisites and benefits was not only required by Section 13(b)(2), but was also necessary to insure that, where required, public disclosure could be made).
standard of care, at least as to matters within the scope of their responsibilities.

To meet this standard, committee members must establish procedures to insure an adequate flow of information to the committee. They must familiarize themselves with the procedures used in maintaining the company's books, records and accounting controls, and they must be prepared, as representatives of the investors, to provide the protection which investors might reasonably expect from an audit committee member.

—ROBERT JAY FORTIN