LEGAL LIABILITY OF AUDIT COMMITTEE MEMBERS IN U.S. SHAREHOLDER DERIVATIVE CASES: LESSONS LEARNED FROM RECENT LITIGATION

Stephen Errol Blythe
Tarleton State University

Key Words: audit committee, legal liability, corporation, shareholder derivative case, litigation, fiduciary duties, Sarbanes-Oxley Act, Securities Exchange Act, control person, oversight

JEL Classifications: K22, M41, M42, M48

Abstract

This study focuses on U.S. shareholder derivative cases in which Audit Committee members were defendants. Three grounds for Audit Committee liability were alleged in those cases: (1) violation of the Fiduciary Duties of Care, Loyalty or Good Faith, which may include failure to provide proper oversight; (2) violation of the Securities Exchange Act (SEA) by issuing an untrue statement regarding the sale of a security; and (3) violation of the SEA because Audit Committee members may be considered to be control persons.

1 | INTRODUCTION

The objectives of this study are to (1) research U.S. shareholder derivative cases in which audit committee members were defendants; and (2) explain the grounds for legal liability employed in those cases.

2 | THE PURVIEW OF A CORPORATION'S AUDIT COMMITTEE

The U.S. Sarbanes-Oxley Act[1] defines an Audit Committee as "A committee (or equivalent body) by and amongst the board of directors of an issuer [of publicly-traded stock] for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer. . ."[2] In its implementation rules, the SEC requires all members of a corporation's Audit Committee to be "financially literate," and one of the members must be a "financial expert."[3] An Audit Committee is typically staffed with 3 to 6 external board members who are not full-time employees of the firm.[4] The breadth of issues falling under the purview of the Audit Committee is wide.[5] Audit Committee members' responsibilities include, but are not limited to: (1) hiring of the external auditor and assessing its qualifications, independence and performance; (2) ensuring that the auditor's informational and documentary needs during the audit are met; and (3) communicating with the auditor and management regarding the auditor's findings.[6]

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[1] *Public Company Reform and Investor Protection Act* ("Sarbanes-Oxley Act"), Pub.L. 107-124, 116 Stat. 745 (2002).

[2] *Id.* at § 205.

[3] Afterman, Allan B. (2019, November). The Audit Committee Financial Expert: A Closer Look at What That Means, *The CPA Journal*. Retrieved from https://www.cpajournal.com/2016/06/12/sec-audit-committee-financial-expert/

[4] Louwers, Timothy J. et al., *Auditing and Assurance Services*, 7th Ed. (New York: McGraw-Hill Education, 2018), p. 181.

[5] *Montini v. Lawler (In re Moduslink Global Solutions Inc. Deriv. Litig.)*, Civil Action No. 12-11296-DJC (D. Mass. 2014) at 3; and *Freuler v. Parker*, Civil Action No. H-10-3148 (S.D. Tex., Houston Div. 2011) at 26-27.

[6] *In re BofI Holding, Inc. Secur. Litig.*, Case No. 3:15-CV-02324-GPC-KSC at 52-53 (S.D. Calif. 2017).

3 | SHAREHOLDER DERIVATIVE CASES

The United States Supreme Court has stated that the shareholder derivative cause of action permits an individual shareholder to file a lawsuit against top managers and directors (including audit committee members)[7] alleged to have engaged in illegal activity to the detriment of the corporation.[8]

4 | METHODOLOGY

Using the *Fastcase* repository of online legal materials,[9] the author looked for all opinions issued by U.S. state and federal courts in shareholder derivative cases in which Audit Committee members were defendants. Thirty-four (34) cases were found; this article focuses on them.

5 | THREE GROUNDS FOR LEGAL LIABILITY OF AUDIT COMMITTEE MEMBERS

The first ground is from common law and the second and third grounds are from statutory law.

5.1 | Ground No. 1: Breach of Fiduciary Duties

Breach of fiduciary duties is a ground for a cause of action against Audit Committee members in a shareholder derivative suit. Audit Committee members owe the firm and its shareholders a Duty of Care and a Duty of Loyalty and a Duty of Good Faith in its relationship with the corporation. The Duty of Care requires that they make a good faith effort to be informed and exercise judgment in the performance of their duties. They must inform themselves, prior to making a business decision, of all relevant and material information reasonably available to them and act with requisite care in the discharge of their duties. The Duty of Loyalty requires that the best interest of the corporation and its shareholders takes precedence over any personal interest possessed

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[7] *Ross v. Bernhard*, 396 U.S. 531, 534 (1970).

[8] *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949).

[9] *Fastcase*. Retrieved from https://www.fastcase.com/

by an Audit Committee member and not shared by the stockholders generally. The Duty of Good Faith requires the Audit Committee members to be honest and fair in its dealings with the corporation.[10]

5.1.1 | Do Audit Committee Members Have a Greater Degree of Fiduciary Duties than Other Members of the Board of Directors? Plaintiffs in shareholder derivative cases frequently allege that Audit Committee members have greater fiduciary duties than other members of the Board of Directors because of their special responsibilities enumerated above.[11] For example, in his complaint, plaintiff Montini stated the "Audit Committee Defendants . . . are particularly culpable because the Audit Committee Charter requires these Board members to coordinate directors' oversight of financial reporting."[12] The fiduciary duties of Audit Committee members must be determined on a case-by-case basis. If a firm's articles of incorporation, Audit Committee charter, other authoritative documents and the firm's *modus operandi* provide evidence that its Audit Committee has a broader purview of duties than other Board members, then a court may hold that the Audit Committee members have been granted an extraordinary amount of authority, responsibility and fiduciary duties.[13]

However, other cases have held that, in the absence of evidence to the contrary, merely alleging the fact of a defendant's Audit Committee membership does not support an inference that the Audit Committee member: (a) knowingly breached a fiduciary duty;[14] (b) knowingly participated in illegal conduct;[15] (c) faced a

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[10] *David Shaev Profit Sharing Account v. Riggio*, 2014 NY Slip Op. 31776(U) at 8, (N.Y. Cty. S.Ct. 2014).

[11] *Montini v. Lawler*, Note 5 at 9.

[12] *Id.*

[13] *In re Alstom SA*, 406 F.Supp.2d 1149 (D.Ariz. 2005).

[14] *South v. Baker*, 62 A.3d (Del. Ch. 2012) at 17; see also, *Markewich v. Collins*, 622 F.Supp.2d 802, 811 (D. Minn. 2009).

substantial likelihood of liability for failing to oversee the firm's compliance with accounting and disclosure requirements;[16] or (d) knew that corporate wrongdoing was occurring.[17] In *Pedroli*, the court held that defendant Le Vecchio's mere membership on the Audit Committee was insufficient to find that he had scienter. The complaint did not allege what duties the Audit Committee was charged with, whether it coordinated outside audits, whether it oversaw various aspects of the firm's financial accounting or what internal controls it enforced. The case was dismissed.[18]

5.1.2 | Violation of Fiduciary Duties of Care and Good Faith Due to Failure to Provide Proper Oversight—*Caremark* claims. Audit Committee members can be held liable for violation of the Duty of Care and the Duty of Good Faith by failing to provide proper oversight over the corporation.[19] Audit Committee members must have knowingly caused or consciously permitted the corporation to violate positive law, or failed utterly to attempt to establish an internal control or other oversight mechanism to monitor the corporation's legal compliance.[20] Because a *Caremark* claim requires a plaintiff to show that the Audit Committee members *knew* they were not discharging their fiduciary obligations (engaging in bad faith) as a necessary prerequisite for Audit Committee member oversight liability, it is sometimes considered to be the one of the most difficult theories to prove in corporation law.[21] Audit Committee members are entitled to a presumption that they were faithful to their fiduciary duties. In

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15 *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008).

16 *Rattner v. Bidzos*, C.A. No. 19700 (Del. Chan. 2003) at 31-37.

17 *Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Chan. 2007).

18 *Pedroli v. Bartek*, 564 F.Supp.2d 683, 692 (E.D.Tex. 2008).

19 *In re Caremark Intern. Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del Ch. 1996).

20 *South v. Baker*, Note 14 at 6.

21 *Id.* at 7, quoting *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

the context of pre-suit demand, the burden is upon the plaintiff in a derivative action to overcome that presumption.[22]

Examples of potential acts of bad faith include: (1) more than half of the directors having knowledge of specific critical warnings ("red flags"); (2) an audit committee that meets infrequently and devotes grossly inadequate time to its work; or (3) facts about the direct and personal involvement in the preparation of erroneous or misleading financial statements by at least half of the directors.[23] However, merely stating a defendant had a duty to monitor and oversee operations is not enough to make a case of scienter without allegations of specific information being available to them or a description of how they were reckless in their duties.[24]

To successfully plead a *Caremark* claim, plaintiff must allege with particularity that there was "a sustained or systematic failure of the [Audit Committee] to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—which establishes the lack of good faith that is a necessary condition to liability."[25] Alternatively, a *Caremark* claim exists if, after establishment of an internal control system, the Audit Committee consciously fails "to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." [26] In either case, plaintiff must show that the Audit Committee members knew they were breaching their fiduciary Duty of Loyalty.

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[22] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048-49 (Del. 2004).

[23] *In re China Auto. Sys. Inc. Deriv. Litig.*, 2013 WL 4672059 at 21-22 (Del. Ch. 2013).

[24] *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F.Supp.2d 474, 497 (S.D.N.Y. 2004).

[25] *Stone v. Ritter*, Note 21 at 372 (quoting *Caremark*, Note 19 at 967-68).

[26] *Stone v. Ritter*, *Id.* at 370.

The court in *Saito v. McCall*[27] found there was a viable *Caremark* claim because the directors were conscious of the fact they were not doing their jobs. In that case, two firms—HBOC and McKesson—were merging and both boards were aware (or should have been) of accounting irregularities at HBOC. Before the merger, the HBOC Audit Committee informed its board of improper accounting practices and that a $40 million restatement of the financial statements was going to be required. The McKesson board later became aware of those improper practices, yet the merger discussions continued, and the merger was consummated. After the merger, the new combined Audit Committee informed the new board that the minimal proposed adjustments to the financial statements were insufficient and problematic, but the board did not approve the necessary adjustments and allowed the erroneous financial statements to be issued. Clearly, this was a case of conscious disregard of the fact that the Audit Committee members knew they were not doing their jobs, and the high bar established in the *Caremark* case was met.[28]

However, in the *Hecla Mining Company* case,[29] the *Caremark* claim failed after plaintiff: (1) alleged the directors failed to ensure the firm was in compliance with all mine safety laws, resulting in an unsafe mine; however, plaintiff failed to state with particularity the specific conduct in which each defendant knowingly engaged, or that defendants knew that such conduct was illegal; (2) alleged the directors were aware of, yet ignored, many "red flags"[30]

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[27] *Saito v. McCall*, Civil Action No. 17132-NC (Del. Ch., New Castle Cty., 2004).

[28] *Saito v. McCall*, *Id.* at 19-24.

[29] *In re Heckla Mining Co. Deriv. Litig.*, Case No. 2:12-CV-00097-REB (D. Ct. Idaho 2014) at 16-22.

[30] A plaintiff's mere labeling of allegations as "red flags" is insufficient to make those allegations relevant to a defendant's scienter. Instead, plaintiffs must plead "facts which come to a defendant's attention that would place a reasonable party on notice that the audited company was engaged in wrongdoing to the detriment of its investors." *In re World Com*, 346 F.Supp.2d 628, 672 (S.D.N.Y. 2004).

providing evidence of safety violations; however, plaintiff did not allege specific facts showing that the defendants consciously failed to act after learning about them, and did not provide evidence indicating the defendants were even aware of the red flags; and (3) alleged the directors allowed the firm to operate without an adequate system of internal controls.[31] The case was dismissed because plaintiff admitted in the complaint that defendants maintained a Safety Committee to oversee the firm's compliance with its health, safety and environmental policies, and plaintiff failed to state specific facts that the Safety Committee was a failure."[32]

5.2 | Ground No. 2: Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5

Section 10(b) of the SEA[33] makes it unlawful for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or . . . for the protection of investors."[34] The Securities and Exchange Commission's Rule 10b-5 implements this provision by making it unlawful to "make an untrue statement of material fact or to omit to state a material fact necessary in order to

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[31] The Delaware Supreme Court held that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." *Graham v. Allis-Chalmers Mfg. Co.*, A.2d 126 (1963), cited in *Freuler v. Parker*, Civil Action No. H-10-3148 (S.D. Tex., Houston Div. 2011) at 15.

[32] *In re Heckla Mining Co.*, Note 29 at 23.

[33] *Securities Exchange Act*, 15 U.S.C. § 78(a) *et seq.*, Pub.L. 73-293, 48 Stat. 881 (1934).

[34] Securities Exchange Act, *Id.* at 15 U.S.C. § 78j(b).

make the statements made, in light of the circumstances under which they were made, not misleading . . .”[35]

In the *Lernout* case,[36] the Audit Committee members were sued under § 10(b) after they signed and filed their firm’s 10-K Report which included fraudulent financial statements. These signatures satisfied the fraudulent statement requirement. Furthermore, the firm’s auditor, KPMG, had informed the Audit Committee that the firm had deficient internal controls and serious accounting, cash collection and revenue recognition issues.

The Audit Committee tried to use KPMG’s unqualified audit opinion as exculpatory evidence, but the court refused to accept this excuse because “the Audit Committee had a duty to oversee the auditors, that is, to guard the guardians.”[37] The court also relied upon the SEC’s statement that “Audit Committees play a critical role in ‘overseeing and monitoring management’s and the independent auditor’s participation in the financial reporting process.’”[38] The court found that the Audit Committee in this case was “reckless in performing this role until at least the November 2000 investigation, after the horse was out of the barn.”[39] Accordingly, the court found that the Audit Committee members

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[35] Securities and Exchange Commission, Rule 10b-5, 17 C.F.R. § 240.10b-5(b). However, the Audit Committee cannot be held liable for alleged false statements, where the plaintiff fails to show that the Audit Committee had knowledge of the falsity and has failed to identify any “red flags’—critical warning signs—in the firm that should have alerted a reasonable Audit Committee member to the falsity. *Murashko v. Hammer*, Civil Action No. 17-cv-2533 (PGS) (TJB) at 9-10 (D. N.J. 2018).

[36] *In re Lernout & Hauspie Secur. Litig. v. Lernout*, Civil Action No. 02-CV-10304-PBS (Consolidated) (D. Mass. 2002).

[37] *Id.* at 3.

[38] *Id.* at 3, citing the U.S. Securities and Exchange Commission, “Audit Committee Disclosure,” Exchange Act Release No. 34-42266 (effective January 10, 2000).

[39] *Id.* at 3.

possessed sufficient scienter and the motion to dismiss was denied.[40]

Similarly, KPMG was the auditor in the *Sunshine Products* case.[41] During its audit of the financial statements, KPMG had given notice to the Audit Committee of illegal acts of the firm's CEO which had been discovered. Notwithstanding this notice, the Audit Committee gave false reassurances, through press releases and Form 8-Ks, that the firm's financial statements were accurate. This violated § 10(b) of the SEA and the Audit Committee members were sued. The Audit Committee members alleged the suit failed to state a 10(b) claim in sufficient detail. However, the court disagreed and denied their motion to dismiss, stating that a plaintiff is only required to plead with particularity sufficient facts to support their beliefs and that a court must evaluate the alleged facts to determine whether they support a reasonable belief that the defendant's statements identified by the plaintiff were false or misleading. The court ruled that plaintiff had met the legal requirements for a § 10(b) claim and the Audit Committee members' motion to dismiss was denied.[42]

Other cases have ruled in favor of the Audit Committee by dismissing the suit. In *Risberg v. McArdle*,[43] the Audit Committee's charter made it responsible for oversight of "the integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements, and the performance of the Company's internal audit function."[44] Allegedly misleading financial statements were issued to the public and were attached to the Annual Form 10-K filed with the SEC. Plaintiff shareholder Risberg filed a derivative lawsuit against the Audit Committee members, alleging a loss in the value of her

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[40] *In re Lernout & Hauspie Secur. Litig. v. Lernout*, Note 36 at 3.

[41] *In re Nature's Sunshine Products Sec. Litig.*, 486 F.Supp.2d 1301 (D. Utah, Central Div. 2007).

[42] *Id.* at 1304-11.

[43] *Risberg v. McArdle*, 529 F.Supp.2d 213, 221-22 (D. Mass. 2008).

[44] *Id.* at 222.

shares caused by the Audit Committee's violation of SEA § 10-b and SEC Rule 10b-5 in allowing the misleading financial statements to be issued to the public.

The court noted that the standard of care establishing an Audit Committee member's liability is ordinarily one of gross negligence. However, the corporation in that case had a broad provision in its charter requiring indemnification of the Audit Committee if it was sued. In a case of this nature, it is not enough for a plaintiff to establish that Audit Committee members *should have known* that a firm's financial statements were false and misleading. Instead, the plaintiff is required to plead facts supporting a reasonable inference that the Audit Committee members *had actual knowledge* that the firm's financial statements were false and misleading.[45]

An Audit Committee's "heightened duty to monitor the corporation's activities and investigate the facts underlying its public statements" is insufficient to establish knowledge and will not substitute for particularized facts establishing the actual knowledge of the Audit Committee members.[46] There will be no liability of Audit Committee members if plaintiff fails to show they were directly responsible for misstatements or omissions in the financial statements. Their execution of financial reports, without more evidence, is insufficient to create an inference that the Audit Committee had actual or constructive notice of any legality.[47] Audit Committee members are typically not held liable for false statements in annual reports, press releases and the like unless they had prior knowledge of the falsity.[48] Accordingly, Risburg's suit was dismissed because she failed to show that the Audit

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[45] *Kococinski v. Collins*, Civil Action No. 12-633 (JRT/JJG) at 14 (D. Minn. 2013).

[46] *In re Xcel Energy, Inc.*, 222 F.R.D. 603, 607 (D. Minn. 2004).

[47] *Campbell v. Yu*, 12 Civ. 3169 (LAK) at 16-17 (S.D.N.Y. 2014).

[48] *Montini v. Lawler*, Note 5 at 20.

Committee members had actual knowledge of the misleading financial statements.[49]

In *Christian v. BT Group PLC*,[50] the Audit Committee members had indicated in the firm's annual report that their Italian subsidiary had some internal control problems. However, the Audit Committee failed to investigate the matter fully and a fraud in that subsidiary was uncovered later. When the Audit Committee was sued under § 10(b), the court held that plaintiff had failed to show that the Audit Committee members had knowledge of the fraud. The mere fact that the Audit Committee members knew there were some internal control problems did not legally require them to launch a full investigation into the matter. Accordingly, the Audit Committee's motion to dismiss the case was granted.[51]

5.3 | Ground No. 3: Audit Committee Members May Be Considered "Control Persons"

This ground for Audit Committee member liability is related to the second ground, above. Section 20(a) of the SEA provides that:

"Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[52]

Section 20(a) was intended to impose liability on controlling persons, such as controlling shareholders and corporate officers, who would not be liable under *respondeat superior* because they

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[49] *Risberg v. McArdle*, Note 43 at 222.

[50] *Christian v. BT Group PLC*, No. 2:17-cv-497-KM-JBC (D. N.J. 2018).

[51] *Id.* at 6-13.

[52] Securities Exchange Act, Note 33 at § 20.

were not the actual employers.[53] Control-person liability is a separate inquiry from that of primary liability and is an alternative theory of culpability.[54] Courts generally take the position that the concept of control has "no clear-cut rule or standard" and that the concept "should be construed liberally and flexibly."[55]

5.3.1 | Is an Audit Committee Member a "Control Person?" Mere membership on the Audit Committee is generally considered to be legally insufficient for invocation of control person liability.[56] A successful plaintiff must state additional facts showing the Audit Committee members had the power to approve the firm's financial statements,[57] or were empowered to sign documents filed with the SEC.[58] In *Alstom*, the court ruled that an allegation of membership on an Audit Committee may, in certain circumstances, serve as the basis of liability under the group pleading doctrine, but not in cases where the allegation of membership on the Audit Committee is too vague and does not specify the Audit Committee member's specific role on the Audit Committee and the period of his service.[59]

However, in the *In re Hayes Lemmertz* case, the court found plaintiff had adequately alleged control person liability of the Audit Committee by stating that it: (1) signed the firm's SEC filings which contained false statements; (2) controlled the firm's accounting and financial reporting; (3) was responsible for assuring that management carried out its responsibilities in preparation of the consolidated financial statements; (4) reviewed

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53 *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990).

54 *In re Alstom SA*, 406 F.Supp.2d 1149 (D.Ariz. 2005).

55 *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1441 (9th Cir. 1987).

56 *In re Alstom*, Note 54 at 499.

57 *Id.*

58 *Id.*, citing *In re Livent, Inc. Noteholders Secur. Litig.*, 151 F.Supp. 2d 144 (S.D.N.Y. 2001).

59 *In re Alstom*, Note 54.

the scope of the audits and the accounting principles applied in financial reporting; and (5) met regularly with the external and internal auditors and management to ensure they were discharging their responsibilities.[60]

Furthermore, in a more recent case, Audit Committee members were found to be control persons because: (1) they were members of the Board of Directors; (2) they owned stock in the company; (3) they were provided with copies of the firm's reports and press releases and they had the power to prevent their issue or to cause them to be corrected; (4) they were aware of the directors' conference calls with investors and had the power to clarify, explain or correct those comments; and (5) they were responsible for overseeing and monitoring the firm's financial statements, internal controls, legal and regulatory compliance, the external auditors, and the internal auditors.[61]

6 | CONCLUSIONS

There are three grounds for legal liability of Audit Committee members.

The first ground is based upon common law. Audit Committee members owe the firm and its shareholders a Duty of Care, a Duty of Loyalty and a Duty of Good Faith. Merely alleging the fact of a defendant's Audit Committee membership does not support an inference that the Audit Committee member violated a fiduciary duty. However, a firm's articles of incorporation, Audit Committee charter, other authoritative documents and the firm's *modus operandi* may provide evidence that Audit Committee members have a broader purview of duties than other Board members. Also, Audit Committee members may be held liable for violation of the

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60 *In re Hayes Lemmertz International Inc. Sec. Litig.*, 271 F.Supp.2d 1007, 1029-30 (E.D. Mich. 2003).

61 *In re BofI Holding, Inc. Secur. Litig.*, Note 6 at 51-54.

Duty of Care and the Duty of Good Faith by failing to provide proper oversight over the corporation.

The second ground comes from statutory law. It is unlawful to make an untrue statement in the commission of a fraud upon any person in connection with the purchase or sale of any security. Audit Committee members may be liable for material untrue statements *knowingly* made in reference to their firm's financial statements.

The third ground also comes from statutory law. Every person who controls any person liable under the second ground shall also be liable jointly and severally with and to the same extent as the controlled person, unless the controlling person acted in good faith and did not induce the unlawful act. Mere membership on the Audit Committee, standing alone, is generally legally insufficient for control person liability. A successful plaintiff must state additional facts showing the Audit Committee members possessed a relatively higher degree of authority and responsibility.

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