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CORPORATE CRIMINAL AND CIVIL LIABILITY

Understanding and Minimizing Risk

Corporations and their officers and directors face potentially significant criminal and civil liability as a result of actions taken by corporate personnel. Counsel must understand this litigation exposure and, more importantly, know how to minimize the risk of liability.

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Now, more than ever, government regulators, shareholders and other third parties carefully scrutinize corporate conduct and demand accountability for wrongdoing. This increased focus has led to the tightening of laws aimed at deterring and punishing corporate misconduct and aggressive enforcement by the government. As a result, corporations face enormous risks, including:

- Indictment.
- Monumental fines.
- Invasive court or third-party supervision of businesses.
- Loss of reputation in the marketplace.
- The cost (both in economic and human capital) to defend themselves.

For officers, directors and management, the risks similarly include indictment, steep fines, debarment, probation or even incarceration.

For example, in what commentators have described as the most prominent corporate prosecution in a decade, on July 25, 2013, the US Attorney for the Southern District of New York unsealed a five-count criminal indictment against the mega-hedge fund S.A.C. Capital Advisors, LLC, CR Intrinsic Investors, LLC and Sigma Capital Management, LLC (collectively, SAC Capital). The indictment charged SAC Capital with criminal responsibility for "systematic" insider trading offenses committed by a number of employees over more than a decade and involving the securities of more than 20 publicly-traded companies across multiple economic sectors.

The government contends that SAC Capital actively encouraged its portfolio managers and research analysts "to pursue aggressively an information edge" and "fostered a business culture within SAC in which there was no meaningful commitment to ensure that such an 'edge' came from legitimate research and not inside information." The charges could threaten the very survival of the company.

In a related action, former SAC Capital portfolio manager, Richard Lee, agreed to plead guilty to one count of conspiracy to commit securities fraud and one count of securities fraud on July 23, 2013. Further, the Securities and Exchange Commission (SEC) filed a civil action against the owner of SAC Capital Advisors, Steven Cohen, accusing him of failing to supervise his employees.

The significant penalties, and the rise in enforcement against both companies and senior corporate executives, make even more important an executive's and a company's assessment of risks related to their business operations. This article offers practical advice to mitigate the risk of corporate criminal and civil liability and examines several key issues that counsel should consider when evaluating a company's litigation risk, including:

- The legal standards for imposing criminal liability on corporations, officers and directors.
- The government's policies on prosecuting corporations for criminal wrongdoing.
- The main sources of civil liability facing corporations, officers and directors.

CORPORATE CRIMINAL LIABILITY

As an artificial or fictional entity, a corporation itself cannot form any intent to commit an act, criminal or otherwise. Instead, it acts only through its officers, employees and agents (collectively referred to in this article as agents). Traditionally, courts have held corporations vicariously liable for torts committed by their agents acting within the scope of their employment duties. The US Supreme Court extended this concept to criminal acts, ruling that a corporation may be held criminally liable for the acts of its agents that were motivated to benefit the company (see *New York Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909)*).

Therefore, if there are adequate grounds to impute criminal intent to a corporation itself, the corporation may be held vicariously criminally liable for any act or omission committed by an agent if that act is committed:

- Within the agent's scope of employment.
- With some intent to benefit the company.

(See *In re Hellenic Inc., 252 F.3d 391 (5th Cir. 2001)*; *Mylan Labs., Inc. v. Akzo, N.V., 2 F.3d 56 (4th Cir. 1993)*; *United States v. Agosto-Vega, 617 F.3d 541 (1st Cir. 2010)*; *United States v. Singh, 518 F.3d 236 (4th Cir. 2008)* and *United States v. Ionia Mgmt. S.A., 526 F. Supp. 2d 319 (D. Conn. 2007)*.)

A corporation may also face liability for acts committed by an agent of the corporation's subsidiary. In addition, corporate officers and directors may be held liable for the misconduct of the company's employees and agents even if they were unaware of the misconduct.

CONDUCT COMMITTED WITHIN SCOPE OF EMPLOYMENT

Generally, the scope of employment requirement is met if the agent has actual or apparent authority to engage in the act in question. Apparent authority is the authority that outsiders would normally assume the agent to have, judging from his position within the company and the circumstances surrounding his past conduct (see *United States v. Bi-Co Pavers, Inc., 741 F.2d 730 (5th Cir. 1984)*).

The term "scope of employment" has been broadly defined to include acts committed on the company's behalf in performance of the agent's general line of work (see *United States v. Hilton Hotels Corp., 467 F.2d 1000 (9th Cir. 1972)*). Therefore, if the agent is performing some job-related duty, the scope of employment element can be established. This is true even if the agent's actions contradict the company's policies or compliance programs (see *United States v. Twentieth Century Fox Film*

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Corp., 882 F.2d 656 (2d Cir. 1989)). It becomes a question of fact whether the company took sufficiently adequate measures to enforce its policies or compliance programs to place the criminal acts outside the scope of the agent's employment (see *United States v. Beusch, 596 F.2d 871, 878 (9th Cir. 1979)* and *Ionia Mgmt. S.A., 526 F. Supp. 2d. at 324*).

INTENT TO BENEFIT THE CORPORATION

A corporation is accountable for an agent's conduct if that conduct is motivated at least in part by a desire to serve the company, but this does not need to be the sole motivation (see *United States v. Gold, 743 F.2d 800 (11th Cir. 1984)*). If the agent's actions benefited the company in some way, government regulators will reject the argument that an agent went "rogue." Conversely, the corporation cannot be held criminally liable for an agent's act if the act was contrary to the company's interests and the company derived no benefit from the act (see *Standard Oil Co. of Tex. v. United States, 307 F.2d 120 (5th Cir. 1962)*).

IMPUTING INTENT TO THE CORPORATION

For criminal liability to attach to the corporation for an act committed by an agent, courts must have a basis on which to impute the agent's act and intent to the corporation. Courts have imputed this intent using several different theories:

- **Willful blindness doctrine.** Under the willful blindness doctrine, a corporation can be held criminally liable for deliberately disregarding the criminal activity at issue (see *United States v. Bank of New England, N.A., 821 F.2d 844 (1st Cir. 1987)*). Therefore, a corporation that suspects wrongdoing but purposely fails to investigate that wrongdoing may find itself criminally liable for the criminal acts committed by its agents.
- **Collective knowledge doctrine.** Federal prosecutors often try to assert that a corporation is criminally liable based on the collective knowledge and conduct of its agents. Under the collective knowledge doctrine, the piecemeal knowledge of several agents can be aggregated to provide the collective knowledge necessary to convict the corporation. This means that a corporation can be held criminally liable even if no single agent has sufficient knowledge to be guilty of the crime. Therefore, corporate criminal liability cannot be avoided simply because the company compartmentalized and divided its agents' duties (see *Bank of New England, N.A., 821 F.2d at 844* and *In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005)*).
- **Misprision of a felony.** A corporation that hides an agent's criminal conduct and fails to report a felony may be criminally liable under the misprision of felony law (*18 U.S.C. § 4*). However, a corporation's mere failure to disclose a felony does not alone create liability. The corporation must take an affirmative step to conceal the felony (see *Itani v. Ashcroft, 298 F.3d 1213 (11th Cir. 2002)*).
- **Conspiracy.** Under federal conspiracy law, two or more persons who agree to commit an offense against the US may be criminally liable, if at least one of the conspirators does something to advance the illegal objective of the conspiracy (*18 U.S.C. § 371*). However, under the Intracorporate Conspiracy Doctrine applied in most civil conspiracy cases, a corporation cannot conspire with its employees and the employees, when acting in the scope of their employment, cannot conspire among themselves (thereby removing the multiplicity of actors necessary to prove the formation of a conspiracy). In contrast to civil conspiracy cases, courts have recognized an exception to the Intracorporate Conspiracy Doctrine for intracorporate criminal conspiracies arising under federal conspiracy law (*18 U.S.C. § 371* and see *McAndrew v. Lockheed Martin Corp., 206 F.3d 1031 (11th Cir. 2000)*). Therefore, a corporation can be criminally charged, convicted and sentenced for conspiring with its own agents to violate the law.

LIABILITY FOR CORPORATE SUBSIDIARIES

Offenses committed by an agent of a corporation's subsidiary can expose the parent company to criminal liability under two legal theories:

- Agency.
- Mere instrumentality or unity of business.

This is true even if the parent acquired the subsidiary through a merger or consolidation after the illegal conduct began (see *United States v. Wilshire Oil Co. of Tex., 427 F.2d 969 (10th Cir. 1970)* and *United States v. Jon-T Chems., Inc., 768 F.2d 686 (5th Cir. 1985)*).

Agency

Under the same reasoning that holds a corporation liable for the illegal acts of its agents, a subsidiary's illegal conduct may be imputed to the parent (see *United States v. Johns-Manville Corp., 231 F. Supp. 690, 698 (E.D. Pa. 1963)*). Under the agency theory of liability, a parent may be liable for the acts of its subsidiary because the subsidiary's employees are either agents or subagents of the parent (*18 U.S.C. § 371*).

A subsidiary's employee may become the parent's agent if the parent has taken some demonstrable step that effectively authorizes that employee to act as the parent's agent for the type of activity in which the illegal conduct occurred. Alternatively, the subsidiary itself could be viewed as the parent's agent when the illegal conduct occurred under the same type of vicarious liability theory discussed above. If the parent's management instructs the subsidiary to commit a crime, the parent will be liable for the subsidiary's misconduct. (See *United States v. Bestfoods, 524 U.S. 51 (1998)* and *Helm v. Alderwoods Group, Inc., 696 F. Supp. 2d 1057 (N.D. Cal. 2009)*.)

Mere Instrumentality or Unity of Business

Under the mere instrumentality or unity of business theory, a parent may be held liable for its subsidiary's misconduct when

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the parent uses the subsidiary to violate the law and does not treat the subsidiary as a separate entity (see *NLRB v. Deena Artware, Inc., 361 U.S. 398 (1960)*). For example, when the parent involves itself in the daily management of the subsidiary, the parent is no longer acting only as an investor in the subsidiary (see *Handlos v. Litton Indus., Inc., 326 F. Supp. 965 (E.D. Wis. 1971)*). Instead, it may be acting as the alter ego of the subsidiary, effectively dominating and controlling the subsidiary to the extent that the subsidiary has no real separate existence.

Courts consider many factors in determining whether or not to impute the actions of a subsidiary to its parent under the mere instrumentality or unity of business theory, including whether:

- The parent and subsidiary have common directors and officers.
- The parent and subsidiary have consolidated financial statements.
- The parent finances the subsidiary.
- The subsidiary is grossly undercapitalized.
- The subsidiary receives only the parent's business.
- The parent uses the subsidiary's property as its own.
- The daily operations of the parent and subsidiary are not separate (for example, both companies are located in the same building and use the same equipment).
- The parent and subsidiary fail to observe corporate formalities, such as required shareholder meetings.

(See *Bestfoods, 524 U.S. at 51*; *Miles v. American Tel. & Tel. Co., 703 F.2d 193, 195-96 (5th Cir. 1983)*; *Key v. Liquid Energy Corp., 906 F.2d 500, 504 (10th Cir. 1990)* and *Sun Microsystems Inc. v. Hynix Semiconductor Inc., 622 F. Supp. 2d 890, 898-99 (N.D. Cal. 2009)*.)

STRICT LIABILITY FOR CORPORATE EXECUTIVES

The Supreme Court established the responsible corporate officer (RCO) doctrine in *United States v. Dotterweich, 320 U.S. 277 (1943)*, holding that anyone with responsibility for advancing an illegal transaction may be held liable for that offense, despite not knowing about the wrongdoing.

The Supreme Court again addressed the issue in *United States v. Park, 421 U.S. 658 (1975)*. Recognizing that many senior officials may be brought within the scope of the RCO doctrine based solely on their formal position in the company, the Supreme Court in *Park* emphasized the "limiting principle" articulated in *Dotterweich*, which restricts liability to corporate officers who are at least partially responsible for advancing the illegal transaction. In other words, a corporate officer without knowledge or involvement in a subordinate's illegal conduct may be held criminally liable for that conduct where the officer either:

- Had actual authority to exercise control over the specific activities that caused the illegal conduct.
- Failed to enact measures to prevent the illegal conduct or, if having implemented control systems, knew of possible violations and failed to carry out his duty to search for and correct them when they occurred.

Application of the RCO doctrine can have serious consequences for corporate executives. For example, in May 2007, several top executives of the Purdue Frederick Company pleaded guilty to charges of misbranding the painkiller OxyContin. Three of those executives pleaded guilty to strict liability RCO misdemeanor charges as "responsible officers" and paid a combined $34.5 million in criminal fines. In addition, the Department of Health and Human Services barred the executives from securing public contracts for 12 years.

The US Department of Justice (DOJ) has announced its intention to pursue RCO cases. However, it has failed to articulate what guidelines it will follow in deciding whether to charge or exclude corporate officers. Accordingly, senior corporate management should be:

- Involved in regularly evaluating the effectiveness of the company's compliance program (see *Box, Reducing Liability with an Effective Compliance Program*).
- Vigilant in identifying and correcting problems.

Search Handling a Government Investigation of a Senior Executive Checklist for steps counsel should take when a senior executive becomes the target of a government investigation.

GOVERNMENT POLICIES AND ENFORCEMENT EFFORTS

In response to the WorldCom and Enron scandals, the federal government took several steps to repair a perceived breakdown of corporate responsibility and ethical standards, including passage of the Sarbanes-Oxley Act of 2002 (*18 U.S.C. § 1514A*) and creation of a Corporate Fraud Task Force. Guidelines to aid in prosecuting and sentencing decisions, which counsel should consider when assessing a company's potential liability, include:

- The guidelines on prosecuting corporations issued by the DOJ.
- The Organizational Guidelines issued by the US Sentencing Commission.

DOJ GUIDELINES

The DOJ's guidelines require prosecutors to consider bringing criminal charges based, in part, on whether or not a corporation has behaved in a way meant to obstruct the government's investigation of corporate misconduct. Though many subsequent versions have been issued, the DOJ's guidelines have remained essentially the same. Generally, a company seeking leniency from the government must:

- Conduct a rigorous internal investigation.
- Disclose to the government the results of that internal investigation, regardless of whether the relevant

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REDUCING LIABILITY WITH AN EFFECTIVE COMPLIANCE PROGRAM

Developing and implementing an effective compliance program offers several advantages, from prosecution through sentencing. For example, an effective compliance program may convince a prosecutor to exercise discretion in bringing charges against the company. It may also demonstrate the company's due diligence in preventing illegal conduct, helping to avoid criminal liability for offenses requiring proof of intent.

In addition, under the US Organizational Guidelines, an effective compliance program may reduce the criminal fines calculated for an offense by significantly lessening the measurement of organizational guilt (see below *US Organizational Guidelines*). However, an effective compliance program may not necessarily insulate a corporation from criminal liability (see *Twentieth Century Fox Film Corp., 882 F.2d at 660* and *United States v. Basic Constr. Co., 711 F.2d 570 (4th Cir. 1983)*).

The key to gaining any reduction in penalties depends on the company's ability to show that its compliance program is effective. Merely having standards of conduct that prohibit wrongdoing is not enough. Key indicators of an effective compliance program include:

- Due diligence to detect and prevent criminal conduct and otherwise promote an organizational culture that encourages ethical conduct and a commitment to complying with the law.
- Oversight of the compliance program by high-level personnel.
- Responsible delegation of authority.
- Continuous employee training.
- Effective hotline and reporting protocols.
- Prompt and adequate investigation of complaints and remediation of deficiencies, including self-disclosure and consistently applied discipline when appropriate.
- A robust monitoring and auditing process that sufficiently addresses the key risk areas for the corporation.

However, a company's compliance program may not reduce penalties if:

- It does not comply with industry standards or applicable government regulations.
- Top executives, in-house counsel or compliance officials were involved in the offense (although recent changes to the Organizational Guidelines provide for the possibility of leniency even if a top executive or other high-level officer was involved in the wrongdoing (see *Organizational Guidelines § 8C2.5(f)*)).
- The corporation failed to timely self-disclose the offense.

In addition, the compliance program must include standards to comply with the requirements of the Sarbanes-Oxley Act. These requirements compel public companies to assess their financial records and reporting systems to ensure that public disclosures to investors are based on sound information gathering and accurate financial records.

information is covered by the attorney-client privilege or work product protection.

The Filip Memorandum

In 2008, the DOJ issued the latest in a series of charging guideline memoranda, commonly referred to as the Filip Memorandum (named after its author, former Deputy Attorney General Mark R. Filip). The Filip Memorandum revises previous guidance on whether a corporation has been cooperative in the government's investigation of corporate misconduct (that is, whether the corporation should receive cooperation credit).

Before the Filip Memorandum, the government gave cooperation credit to a corporation for waiving attorney-client privilege or work product protection when disclosing information relevant to the government's investigation. In contrast, the Filip Memorandum states that cooperation credit will not depend on the waiver of attorney-client privilege or work product protection, but instead will focus on the corporation's willingness to disclose relevant facts. A corporation that does not disclose the relevant facts about the alleged misconduct to the government for any reason should not be entitled to receive cooperation credit (*US Attorneys' Manual 9-28.720(a)*).

The problem with this position, however, is that the relevant facts counsel uncover during an internal investigation are the result of extensive document reviews and witness interviews and may therefore constitute protected work product. The Filip Memorandum attempts to sidestep this issue by stating that it is up to the organization to decide whether to conduct

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an internal investigation in a privileged or non-privileged manner, explicitly disclaiming any view on whether otherwise protected information must be disclosed and, instead, focusing on the DOJ's need to obtain the facts.

In addition, the Filip Memorandum provides that when deciding whether to charge a company with wrongdoing, the government may no longer consider whether the corporation advanced attorneys' fees to employees or entered into a joint defense agreement.

Search Internal Investigations: US Privilege and Work Product Protection for information on ensuring the proper creation and maintenance of the attorney-client privilege and work product protection during an internal investigation.

Search Joint Defense and Confidentiality Agreement for a sample joint defense agreement, with explanatory notes and drafting tips.

US ORGANIZATIONAL GUIDELINES

The US Organizational Guidelines are set out in Chapter 8 of the US Sentencing Guidelines, published by the US Sentencing Commission. The Organizational Guidelines apply to:

- Corporations.
- Partnerships.
- Associations.
- Unions.
- Trusts.
- Pension funds.
- Non-profit organizations.
- Joint-stock companies.
- Governments.
- Political subdivisions.

The Organizational Guidelines were intended to address the problem of inconsistent sentencing by establishing a process for punishment based on the severity of the offense and the guilt of the organization. Federal courts are no longer required to follow the Sentencing Guidelines, but they must consult and consider the Sentencing Guidelines when imposing a sentence (see *United States v. Booker, 543 U.S. 220 (2005)*).

The severity of the offense is generally measured by:

- The victim's loss.
- The defendant's gain.
- Other factors relevant to determining the level of the offense.

The organization's guilt is determined by:

- The measures taken to prevent and detect criminal conduct before the offense occurred.
- The level of involvement in, or tolerance of, the offense by the organization's executives and managers.
- The cooperation the organization provided to government authorities once the offense was discovered.

The measurement of organizational guilt under the Organizational Guidelines may impact the fines assessed for the offense. A corporation that can demonstrate it instituted a strong and effective compliance program capable of detecting and preventing wrongdoing (see *Box, Reducing Liability with an Effective Compliance Program*), and cooperated fully during the government's investigation of the offense, can significantly reduce penalties. This reduction is based on whether the corporation:

- Acted in good faith and with reasonable foresight.
- Suffered from rogue employee behavior or an unusual and unanticipated failure.

CORPORATE CIVIL LIABILITY

Publicly traded corporations, as well as their officers and directors, are subject to federal laws that govern the initial and subsequent sale of securities. Liability for violating the US securities laws poses some of the greatest risks to these companies and corporate executives, including:

- Enforcement actions by the SEC.
- Derivative lawsuits brought by the company's shareholders.

The two principal federal securities laws are the Securities Act of 1933, as amended (Securities Act), which deals primarily with the initial issuance of securities, and the Securities Exchange Act of 1934, as amended (Exchange Act), which regulates securities trading after the initial issuance.

Activities that may give rise to corporate liability for securities fraud or other violations include:

- Public offerings.
- Reporting and disclosure.
- Takeovers.
- Dealings with shareholders.

Corporations, officers, directors and others who violate these laws are subject to:

- Criminal penalties.
- Civil penalties.
- Administrative fines.
- Cease and desist orders.
- Injunctions.
- Disgorgement.
- Private lawsuits.
- Orders barring them from acting as officers or directors of public companies.

SEC ENFORCEMENT ACTIONS

The SEC enforces both the Securities Act and the Exchange Act. The SEC may bring a case in federal court or within the SEC before an administrative law judge. Its decision on the method often depends on the type of sanction or relief sought.

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A corporation that can demonstrate it instituted a strong and effective compliance program capable of detecting and preventing wrongdoing, and cooperated fully during the government's investigation of the offense, can significantly reduce penalties.

For example, the SEC may bar someone from the brokerage industry through an administrative proceeding, but must go through the federal courts to bar someone from acting as a corporate officer or director. If the misconduct warrants it, the SEC may elect to bring both proceedings.

Common violations of the securities laws that may lead to SEC enforcement and corporate liability include:

- Misrepresenting or omitting important information about securities.
- Manipulating the market prices of securities.
- Stealing customers' funds or securities.
- Treating broker-dealer customers unfairly.
- Insider trading (that is, violating a trust relationship by trading on material, non-public information about a security).
- Selling unregistered securities.

Cooperation Credit: The SEC's Seaboard Report

A corporation that has become the target of an SEC investigation can take action to receive cooperation credit and avoid liability. In 2001, the SEC issued a formal release, known as the Seaboard Report (available at *sec.gov*), announcing that it was taking no action against Seaboard Corporation because of Seaboard's complete cooperation with an SEC investigation. The SEC investigation stemmed from the misconduct of the former controller of Seaboard's subsidiary, which had resulted in Seaboard's inaccurate books and records and misstated periodic reports.

The SEC cited 13 factors that it considered in reaching its decision not to take action against Seaboard and announced it would consider these factors in future investigations when deciding whether to grant cooperation credit. The factors include whether the company:

- Promptly, completely and effectively disclosed the existence of the alleged misconduct to the public and regulators.
- Conducted, or had an outside entity conduct, an internal review of the alleged misconduct.
- Promptly disclosed the result of the internal review to the SEC, including a detailed and inquisitive written report detailing the review's findings.

Despite recognizing the public interest in preserving privileges, the Seaboard Report indicates that, as part of a company's cooperation, it may be necessary to waive privileges and protections. In both the Seaboard Report and subsequent cases, the SEC has cited a company's decision to provide complete information to the SEC without asserting attorney-client privilege or work product protection as an important factor in the SEC's determination to provide cooperation credit for cooperation in settlements.

Cooperation Credit: The SEC's Enforcement Manual

The SEC Division of Enforcement Manual (Enforcement Manual) (available at *sec.gov*), released in 2012, helped improve the transparency of the Enforcement Division's procedures and provided further guidance on when a company should receive cooperation credit. Although the Seaboard Report still applies, the Enforcement Manual makes several significant statements that are not in the Seaboard Report.

Section 4.3 of the Enforcement Manual, for instance, directs SEC attorneys not to ask for attorney-client privilege or work product protection waivers. The Enforcement Manual also states that while the notes and memoranda of employee interviews conducted by corporate counsel during an internal investigation may be privileged, "the underlying factual information disclosed by the witnesses during the interviews is not privileged."

These new pronouncements appear consistent with the Filip Memorandum's cooperation standards (see above *The Filip Memorandum*). It is unclear, however, whether (and to what extent) a party may enhance its cooperation credit by not only disclosing the facts, but also waiving privilege and turning over attorneys' notes and memoranda. The proposed Attorney-Client Privilege Protection Act of 2009 (available at *govtrack.us*) would have resolved that uncertainty by prohibiting government attorneys from attaching any weight whatsoever

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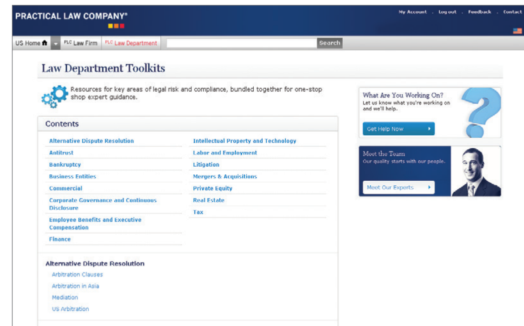
CONDUCTING INTERNAL INVESTIGATIONS TOOLKIT

The Conducting Internal Investigations Toolkit available on practicallaw.com offers a collection of resources that counsel can use to assist employers in preparing for and conducting effective internal investigations. The Toolkit features a range of continuously maintained resources, including:

- Internal Investigations: US Privilege and Work Product Protection
- Whistleblower Protections under Sarbanes-Oxley and the Dodd-Frank Act
- Memorandum to Employees Regarding Proper Maintenance of the Attorney-Client Privilege
- Litigation Hold Notice
- Conducting an Internal Investigation Checklist
- Handling a Government Investigation of a Senior Executive Checklist



to a privilege waiver when making charging or enforcement decisions about the corporation, but ultimately the bill was not enacted.

Control Person Liability

Section 20(a) of the Exchange Act provides that a person who controls another person found liable for securities fraud under the Exchange Act is jointly and severally liable, "unless the controlling person acted in good faith and did not directly or indirectly induce" the violation (*15 U.S.C. § 78t*). Section 929P(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 clarifies Section 20(a) to expressly authorize the SEC to bring enforcement actions against control persons. Generally defined, a control person is anyone in the organization who holds significant decision-making authority, such as senior executives (chief executive officers, chief financial officers and chief compliance officers, among others), board members and owners of broker-dealers.

Typically, control persons face charges when they have had direct involvement in, or knowledge of, a violation. In *SEC v. Nature's Sunshine Products, Inc.*, however, the SEC charged a parent corporation with violating the Foreign Corrupt Practices Act's (FCPA's) anti-bribery, books and records and internal controls provisions, as well as other securities laws, based solely on conduct undertaken by its Brazilian subsidiary (see *SEC Litig. Release No. 21162, No. 09-cv-0672 (D. Utah, Filed July 31, 2009)*). The SEC also charged two of the company's executives with violating the FCPA's books and records and internal controls provisions under the control person theory, even though the SEC never alleged that the executives either were involved in, or had personal knowledge of, the illegal activity.

Until the passage of Section 929P(c), the US Courts of Appeals were split over whether the SEC could maintain an enforcement action for control person liability under Section 20(a) (see *SEC v. First Jersey Secs., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996)*; *SEC v. J.W. Barclay & Co., Inc., 442 F.3d 834, 842 (3d Cir. 2006)* and *SEC v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974)*). There still remains a circuit split over whether Section 20(a):

- Requires a prima facie showing of the control person's "culpable participation."
- Does not require a showing of the control person's culpable participation, but requires a showing only that:
  - the defendant actually participated in the operations of the business; and
  - the defendant had power to control the transaction or activity giving rise to liability.

(See *In re Nat'l Century Fin. Enters., Inc., 504 F. Supp. 2d 287, 301-303 (S.D. Ohio 2007)* (discussing circuit split on required showing).)

Given the confirmation of the SEC's authority to bring enforcement actions based on control person liability, counsel should expect more of them in the future and should review the case law in the applicable circuit.

Search Trends in Federal White Collar Prosecutions for more on recent FCPA enforcement.

SHAREHOLDER DERIVATIVE ACTIONS

Corporations that have violated the securities laws may also be exposed to shareholder derivative actions. When directors or officers harm their corporations, the law permits a shareholder (that is, the derivative plaintiff) to initiate an action, theoretically on behalf of the corporation, to protect (and benefit) all of the corporation's shareholders from improper management.

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Shareholder derivative lawsuits usually involve claims against the corporation's officers and directors for breach of fiduciary duty. The fiduciary duties directors and officers owe their corporations include the duties of due care and loyalty, and require directors and officers to obey the law. Claims for breach of fiduciary duty typically arise when a company's directors and officers cause the company to break the law, exposing it to criminal or civil penalties, massive losses and damaging litigation, including securities fraud class actions.

Representation Issues

A recurring issue in shareholder derivative actions is the extent to which an attorney or law firm can represent both the corporation and:

- The directors or officers who have allegedly harmed the corporation.
- The special litigation committee, if applicable.

The majority view holds that where the plaintiffs are making a claim that directors or officers have harmed the corporation, the corporation needs counsel independent from the directors' and officers' counsel (see *Bell Atl. Corp. v. Bolger, 2 F.3d 1304 (3d Cir. 1993)* and *Natomas Gardens Inv. Group LLC v. Sinadinos, No. 08-cv-2308, 2009 WL 4282054 (E.D. Cal. Nov. 25, 2009)*).

In the special litigation committee context, retaining separate independent counsel is an important factor in a court's decision to accept the committee's recommendation to dismiss, settle or proceed with an action. The corporation's board often appoints a special litigation committee to evaluate the merits of a derivative action after a shareholder either:

- Makes a demand on the board to pursue litigation on behalf of the corporation or to refrain from taking a specified action.
- Commences a derivative action without first making a demand on the board.

The court may dismiss the derivative action based on the special litigation committee's conclusion that the suit is meritless. If, however, the committee did not have separate counsel independent from the corporation's counsel, courts generally will not dismiss the derivative action based on the special litigation committee's assessment of the merits of the case.

For example, the US Court of Appeals for the Eleventh Circuit held that a derivative action could not be dismissed when the law firm conducting the investigation on behalf of the outside directors was also the general counsel for the corporation (see *Stepak v. Addison, 20 F.3d 398 (11th Cir. 1994)*). Likewise, the US District Court for the Southern District of New York denied a motion to dismiss a derivative action, in part, because the special litigation committee was not represented by independent counsel (see *In re Par Pharm., Inc. Derivative Litig., 750 F. Supp. 641 (S.D.N.Y. 1990)*).

Search Shareholder Derivative Litigation: Special Litigation Committees for more on the role of special litigation committees in shareholder derivative litigation.

The Business Judgment Rule

Directors and officers may be personally liable to the company's shareholders for certain actions taken by the company. However, in many instances, this potential liability is tempered, if not eliminated, by application of the business judgment rule. The business judgment rule creates a rebuttable presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company (see *Gantler v. Stephens, 965 A.2d 695, 705 (Del. 2009)*). This presumption may be rebutted if the plaintiff can show that either:

- The directors who approved the transaction were neither disinterested nor independent.
- The transaction was not the product of the board's good faith or informed business judgment.

(See *Mann v. GTCR Golder Rauner, L.L.C., 483 F. Supp. 2d 884 (D. Ariz. 2007)* and *Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*.)

The business judgment rule is rooted in common law, but has been significantly developed in modern times by the Delaware Court of Chancery. It protects and promotes the role of the board of directors as the ultimate manager of the corporation (see *In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005)*). Under the business judgment rule, courts will not second-guess a business decision if corporate management exercised a minimum level of care in arriving at the decision (see *Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), overruled on other grounds by Gantler, 965 A.2d 695*; *Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003)* and *Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993)*).

Best Practices for Boards

Because the board's deliberations may be scrutinized in future shareholder litigation, it is important not to take action in a rushed and uninformed manner. For example, there should be evidence that the directors took steps to ensure that they were fully informed about all material information reasonably available to them before taking action, including by:

- Obtaining and reviewing relevant materials before any board meeting, such as the agenda and copies of all relevant documentation.
- Ensuring that the board's minutes and supporting memoranda and documents clearly demonstrate a good faith basis for all of its decisions.
- Without waiving privileges, making sure the board's minutes reflect that the board consulted with experts and legal counsel, where appropriate.

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