

## Control Person Liability

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Entering the securities law almost unnoticed amidst the blockbuster provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), a 13-word parenthetical phrase grants the Securities and Exchange Commission (SEC) unequivocal authority to bring monetary and injunctive claims against directors, officers, and other control persons for violations committed by their subordinates. With the passage of the amendment, the SEC can litigate these actions in courts that once barred or discouraged them. In practice, its ability to do so may translate into more aggressive enforcement against a broader class of control persons, including those who have not committed primary violations of the securities law.

Section 929P(c) is found under Title IX, Subtitle B, of the Dodd-Frank Act. It amends Section 20(a) of the Securities Exchange Act of 1934 (Exchange Act) to expressly empower the SEC to bring an action against a control person when his, her, or its controlled person violates the Exchange Act. Private plaintiffs have sued under this provision for decades, but the SEC has had mixed success and its enforcement efforts have been subdued. Due to conflicting decisions among the United States Courts of Appeal, the law was unsettled as to whether the SEC could bring actions under the statute and, if so, when. This has meant that, over the years, the SEC has only infrequently pursued control person claims and, in most cases, only as additional claims against individuals that the SEC was also charging as prima-

ry violators. The new provision defines the SEC's enforcement authority expansively, meaning that directors, officers, and other control persons may now be liable for penalties running into the hundreds of thousands of dollars and disgorgements running into the millions. To protect themselves, these control persons should consider improving their companies' internal systems of control and should reevaluate appropriate levels of D&O insurance.

### *Previously Unsettled Law*

The original Section 20(a) became law with the rest of the Exchange Act in 1934.<sup>1</sup> The statute was reportedly motivated by Congress' concern that controlling persons could "escape liability by interposing 'dummy directors' or other intermediaries."<sup>2</sup> The scope of the SEC's enforcement authority was not defined in the original law, however, and it remained largely undefined until last year. Particularly since the mid-1970s, overlapping circuit court splits shielded directors, officers, and other control persons from the full brunt of enforcement actions based either solely or predominantly on their subordinates' violations of the security law.

The most important circuit split involved SEC enforcement power. In 1974, the Sixth Circuit held that the SEC was not a "person" within the meaning of Section 20(a) and therefore could not bring actions under the statute.<sup>3</sup> One year later, the Second

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Circuit upheld the SEC's authority to bring such actions under Section 20(a) and, after some shaky steps, confirmed this authority in 1996.<sup>4</sup> While the Third Circuit followed the Second,<sup>5</sup> district courts in other circuits, citing the few decided appeals court cases as more or less persuasive authority for their holdings, reached differing conclusions.<sup>6</sup>

#### *Remaining Circuit Split*

Although the Dodd–Frank Act addressed the question of whether the SEC had authority to bring such cases, a remaining circuit split relating to the elements of a control person charge will be relevant as the SEC starts exercising its new authority. Some circuits interpreting the relevant provisions require a prima facie showing of the control person's "culpable participation," while others only require (1) that the defendant actually participated in the operations of the business, and (2) that the defendant had power to control the transaction or activity giving rise to liability. Notably, the Second and Third Circuits employ the culpable participation test while courts in the First, Fifth, Sixth, Seventh, Eighth, Ninth, and Tenth Circuits have employed versions of the less rigorous test.<sup>7</sup> Under this regime, the limits that different circuits construed around Section 20(a) meant in practice that where the SEC's enforcement power was stronger, the statute's punch was weaker, and vice versa. The Second and Third Circuits sanctioned the SEC's power to bring actions under the statute but required it (or any plaintiff) to show that the defending control person had culpably participated in the primary securities violation. The Sixth Circuit, however, rejected the culpable participation requirement but refused to let the SEC enforce Section 20(a).

#### *Enforcement Under the Old Regime*

The effect of these splits was evident in the SEC's enforcement patterns. We have reviewed SEC litigation releases and associated paperwork dating back to 1999. Although these do not provide an exhaustive catalog of enforcement actions, they tend to

show that the SEC has filed few Section 20(a) control person claims in the last decade. The collected releases record SEC control person claims against 35 natural persons and two companies since the beginning of 2002. The distribution of these claims tends to reflect the circuits' different understandings of the SEC's authority: they were filed against twelve persons in Second Circuit district courts, five persons in Third Circuit courts, one person in a Sixth District court, and 19 persons in all other district courts.

The releases also tend to show the effect of the culpable participation rule on the SEC's enforcement patterns. In the Second and Third Circuits' district courts, where showings of culpable participation are required, eight of the sixteen natural persons sued also faced criminal prosecutions in connection with primary securities violations; in the Third it was five for five. Only two of the 19 persons sued in the other circuits have been prosecuted.

Until recently, and across all circuits, the typical enforcement approach has been to assert claims premised on primary liability before tacking on claims under the control person statute. It has been the rare complaint, like that filed against former AIG CEO Maurice Greenberg in 2009, that charges a defendant only as a control person.<sup>8</sup> Overall, the pattern tends to show that the SEC was not comfortable filing claims in federal court based solely on the control person theory, either because it was unsure that the court would uphold its authority to do so, or because it could not escape the need to make some showing as to the defendant's culpability.

#### *Enhanced Enforcement Power*

The language Dodd-Frank adds to Section 20(a) will likely eliminate the SEC's reluctance to bringing cases against control persons. Though the specific implications of Section 929P(c) are not explicitly spelled out in the public record, the new language is unambiguously intended to enhance the SEC's enforcement power. A Conference Committee Expla-

natory Statement asserts that the Title IX, Subtitle B, which contains the provision, “strengthens the SEC’s authority to conduct investigations, impose liability on control persons, and assess penalties for violations of the securities laws.”<sup>9</sup> With respect to control person liability, the revisions to the securities laws accomplish this goal in two ways.

First, the new language in Section 20(a) resolves the circuits’ split over SEC enforcement power. The statute now defines the SEC as a potential “person to whom [a] controlled person is liable.” Uncertainty about the SEC counting as a “person” under the statute was the primary cause of the circuit split: some courts found that the statute’s “context,” its neighborly relation to the unequivocal standard for enforcement in Section 20(b), implied Congressional intent to exclude the SEC from the definition of “person.”<sup>10</sup> Now there is no mistaking the explicit legislative mandate that the SEC be regarded as a person capable of bringing suit under Section 20(a).<sup>11</sup>

Second, Dodd-Frank may allow the SEC to take advantage of its newly-confirmed control person authority without needing to worry about the “culpable person” circuit split. Section 929E of the Dodd-Frank Act grants the SEC power to serve subpoenas anywhere in the nation for claims brought under the Securities Act of 1933, Exchange Act, Investment Company Act of 1940, and Investment Advisers Act of 1940. A specific discussion of that section’s provisions is beyond the scope of this article, but they have important implications for the discussion. The SEC, presuming it can show proper venue, need not file its cases in the Second or Third Circuit, because it has nationwide service of process and can apparently compel witnesses to attend trials in jurisdictions with friendlier pleading standards.

The cumulative effect is (1) to give the SEC explicit power to bring Section 20(a) actions against control persons in any district court in the country, and (2) to allow the SEC greater flexibility to choose where to bring these actions. While the Second and Third

Circuits might maintain their “culpable participation” requirements, the SEC is no longer constrained by the fact that these are the circuits most friendly toward its enforcement power.

#### *Next Steps*

In the new regulatory environment, there are two things control persons should consider doing to protect themselves from the threat of liability: (1) prevent violations and lay the groundwork for strong affirmative defenses; and (2) examine D&O insurance.

#### *Prevent Violations and Lay Groundwork for Strong Affirmative Defenses.*

Whether or not a jurisdiction has a culpable participation requirement, the control person’s best defense may be found under Section 20(a)’s provision that liability does not attach where “the control person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.” Courts have interpreted this clause to mean that a control person may argue, as an affirmative defense, that he, she, or it had in place “a reasonable and proper system of supervision and internal control.”<sup>12</sup> In all events, this requires the controlling person or entity to take sufficient precautions to prevent securities violations before they happen. This means the entity or person must provide training, supervision, and guidance appropriate to the nature of the business and project the proper “tone from the top” at all times. Controlled persons must understand that misconduct will not be tolerated. Control persons should consider conducting a risk assessment of potential areas of concern, and then (1) update policies and procedures, (2) implement tiered and targeted training, and (3) establish a monitoring/internal audit program designed to access the strength and success of the compliance programs. Different risks (e.g., financial reporting or anticorruption risks) will require different approaches. These systems should be updated as a business’

operations develop and with attention to enforcement trends and changing regulatory schemes.

#### *Examine D&O Insurance*

Dodd-Frank equips the SEC with unequivocal authority to bring Section 20(a) claims against control persons. With a greater likelihood that these claims will succeed comes a greater probability that they will be attempted. Thus, control persons should be mindful that they now have a significantly greater chance of being found liable where they have not committed primary violations. Control persons must consider these risks when obtaining D&O insurance and should consult their insurance professionals to ensure that their policies are appropriately tailored to consider the potential new claims.

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<sup>1</sup> LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 11.D(1) (1992).

<sup>2</sup> *Id.*

<sup>3</sup> See *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974).

<sup>4</sup> *SEC v. First Jersey Securities*, 101 F.3d 1450 (2d Cir. 1996).

<sup>5</sup> See *SEC v. Barclay*, 442 F.3d 834 (3d Cir. 2006).

<sup>6</sup> Compare *SEC v. Buntrock*, 2004 U.S. Dist. LEXIS 9495 at \*27-28 (N.D. Ill. 2004) (upholding the SEC's authority); *SEC v. Fitzgerald*, 135 F. Supp. 2d 992 (N.D. Cal. 2001) (upholding the SEC's authority) with *SEC v. Stringer*, 3:02-CV-01341-ST (D. Or. 2003) (unreported decision) (refusing to allow the SEC to bring a claim under Section 20(a)).

<sup>7</sup> See *In re National Century Financial Enterprises*, 504 F. Supp. 2d 287 at 301-303 (E.D. Oh. 2007).

<sup>8</sup> See complaint, *SEC v. Greenberg* (Aug. 6, 2009) available at <http://www.sec.gov/litigation/complaints/2009/comp21170.pdf>. The SEC recently filed another settled enforcement action against executives based solely on control person liability. See *v Prods., et al.*, 2:09-CV-00672 (D. Utah July 31, 2009), SEC Litigation Release No. 21162 (July 31, 2009).

<sup>9</sup> Joint Explanatory Statement of the Committee Conference 871, available at <http://www.llsdc.org/attachments/files/251/Dodd-Frank-Act-Jt-Expl-Statement.pdf>, (June 29, 2010).

<sup>10</sup> *Stringer*, 3:02-CV-01341-ST (unreported decision).

<sup>11</sup> See also THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION, § 12.24[1] (Suppl. 2011) (noting that the new provision "resolves this apparent split of the circuits by clarifying that the SEC can rely on control person liability in enforcement actions").

<sup>12</sup> LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 11.D(1) (1992) (quoting *Marbury Management v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980)).