Corporations, Directors, and Officers: Potential Criminal and Civil Liability

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This practice note provides an overview of the law and legal standards governing the imposition of criminal liability on officers, directors, and corporations for the acts of employees. The practice note discusses the federal government's policies and procedures in corporate criminal investigations and prosecutions, and the most common areas of corporate civil liability under the federal securities laws.

This practice note specifically addresses the following key issues in civil and criminal corporate liability:

- Vicarious Criminal Liability for Corporations and Executives
- Assessing Potential Criminal Liability under Department of Justice (DOJ) Guidelines
- Criminal Liability under Federal Employment Laws
- Corporate Sentencing and Establishing Effective Compliance Programs
- Civil Liability in SEC Enforcement Actions
- Civil Liability in Shareholder Direct and Derivative Actions

Although this practice note covers federal law, many of the topics addressed below also may implicate state laws, depending on the circumstances.

Be mindful that what begins as a commercial or civil matter may ultimately have consequences under criminal statutes as well. Similarly, regulatory investigations into potentially criminal conduct often result in civil litigation brought by contractual counterparties or shareholders. Thus, it is important to involve counsel with both criminal and civil expertise at the onset of a dispute or investigation. Finally, we emphasize the importance for corporations to develop and nurture a culture of rigorous compliance with the laws and regulations applicable in their respective industries. A substantive compliance program is both a significant mitigating factor considered by prosecutors in assessing penalties and a bedrock best corporate practice in a post-Enron, post-credit crisis environment.

VICARIOUS CRIMINAL LIABILITY FOR CORPORATIONS AND EXECUTIVES

Corporations can be charged with committing crimes. Federal criminal statutes apply to "whoever" or to any "person" who violates their prohibitions, terms which include not only individuals, but also corporations, companies, associations, firms, and partnerships. See, e.g., 18 U.S.C. §§ 371, 1956; 1 U.S.C. § 1.

As a legal entity that exists only in documents, a corporation is incapable of independently forming the mens rea necessary to commit a criminal act. Instead, the corporation acts through its employees and agents. Some U.S. states hold corporations criminally liable only for the acts of directors or senior managers. See, e.g., Model Penal Code § 2.07; Ariz. Rev. Stat. Ann. § 13-305. By contrast, federal law generally ignores an employee or agent's level of responsibility. See, e.g., United States v. Singh, 518 F.3d 236, 249–50 (4th Cir. 2008).

Respondeat Superior

The most prominent theory of corporate criminal liability is respondeat superior. Originally developed in tort law, respondeat superior holds corporations both civilly and criminally liable for the acts of their employees and agents, so long as the acts were carried out within the scope of their authority and, at least in part, for the benefit of the corporation. New York Cent. & Hudson R.R. Co. v. United States, 212 U.S. 481, 494–95 (1909).

The general proposition that a parent corporation is not liable for the criminal acts of a subsidiary does not apply in all circumstances. A parent's liability for a subsidiary's bad acts can arise under one of two variations on respondeat superior:

- First, the subsidiary may be the agent of the parent, and the employees of the subsidiary may be the sub-agents of the parent.
- Second, the two corporations may be so intertwined that the two companies are treated as a single enterprise, such that the employees of the subsidiary are effectively the employees or agents of the parent.

See, e.g., United States v. Johns-Manville Corp., 231 F. Supp. 690, 698 (E.D. Pa. 1963).

Liability for the Conduct of Employees and Agents

Under respondeat superior, two elements must be present for a corporation to be liable for the criminal acts of an employee or agent:

- First, the employee or agent must have committed a criminal act within the scope of his or her authority with the corporation.
- Second, the employee or agent must have acted with the intent, at least in part, to benefit the corporation.

New York Cent. & Hudson R.R. Co. v. United States, 212 U.S. 481, 494–95 (1909); United States v. Demauro, 581 F.2d 50, 53 (2d Cir. 1978).

Scope of Authority and Scope of Employment

The scope of authority requirement generally is met when the employee or agent had actual or apparent authority to engage in the type of act that gave rise to liability. Actual authority, also called express authority, arises when a corporation, through its words or actions, objectively leads its employee or agent to reasonably believe that he or she may act on behalf of the corporation. Restatement (Third) of Agency § 2.01. Apparent authority is the authority that outsiders would normally assume the agent to have, judging from his or her position within the corporation and the circumstances surrounding his or her past conduct. See, e.g., United States v. Bi-Co Pavers, Inc., 741 F.2d 730, 737 (5th Cir. 1984).

Similarly, the term "scope of employment" has been defined to include acts committed on the corporation's behalf "in performance of the agent's general line of work." See United States v. Hilton Hotels Corp., 767 F.2d 1000, 1004 (9th Cir. 1972); Hamm v. United States, 483 F.3d 135, 138 (2d Cir. 2007). Courts generally have found that an employee or agent acts within the scope of authority or the scope of employment for attributing individual conduct to a corporate entity so long as he or she is performing a job-related duty, or an act of the kind he or she is authorized to perform, even if the specific act is contrary to express instructions or to company policy. See, e.g., United States v. Agosto-Vega, 617 F.3d 541, 552–53 (1st Cir. 2010); United States v. Hilton Hotels Corp., 467 F.2d 1000, 1004 (9th Cir. 1972); United States v. Twentieth Century Fox Film Corp., 882 F.2d 656, 660 (2d Cir. 1989).

Intent to Benefit the Corporation

For the corporate benefit element to be met, an employee must be motivated at least in part by a desire to serve the corporation. See, e.g., United States v. Demauro, 581 F.2d 50, 54 & n. 3 (2d Cir. 1978). The key question is what the employee intended. The employee's act need not actually confer a benefit upon the corporation, and may instead result in harm to the corporation. See, e.g., United States v. Ionia Management S.A., 526, F. Supp. 2d 319, 323 (D. Conn. 2007), aff'd, 555 F.3d 303 (2d Cir. 2008). So long as at least one of the employee's intentions was to benefit the corporation, the corporate benefit element is met. See, e.g., Standard Oil Co. of Texas v. United States, 307 F.2d 120, 128–29 (5th Cir. 1962). Courts may then impute the employee's conduct to the corporation. Notably, a corporation can be held criminally liable for "willful blindness" to illegal activity by its personnel. See, e.g., Acclaim Sys., Inc. v. Infosys, Ltd., 679 Fed. App'x 207, 212 (3d Cir. 2017). Corporations also may be found criminally liable based on the collective knowledge of its employees of the wrongdoing atissue. See, e.g., United States v. Pac. Gas & Elec. Co., 2015 U.S. Dist. LEXIS 171577, at *8 (N.D. Cal. Dec. 23, 2015).

Liability for the Conduct of Corporate Subsidiaries

A parent corporation may be held liable for the criminal acts of a subsidiary. This may be true even when a parent corporation acquires a subsidiary through a merger or acquisition that takes place after the criminal act occurs. See, e.g., United States v. Wilshire Oil Co. of Tex., 427 F.2d 969, 973–74 (10th Cir. 1970); United States v. Countrywide Fin. Corp., 961 F. Supp. 2d 598 (S.D.N.Y. 2013). Courts have reasoned that to do otherwise would permit companies to avoid liability by reorganizing themselves. See, e.g., United States v. Alamo Bank of Tex., 880 F.2d 828, 830 (5th Cir. 1989).

A parent corporation's liability for the acts of a subsidiary generally arises under one of two legal theories:

- First, under the agency theory, liability may attach to a parent corporation where its subsidiary or the subsidiary's employees are agents or sub-agents of the parent.
- Second, under the mere instrumentality or veil piercing theory, a parent may be liable for its subsidiary's actions when the parent does not treat the subsidiary as a separate entity and uses the subsidiary to commit a crime.

Agency Theory

The agency theory of criminal liability applies in the parent-subsidiary context. The fact that a subsidiary is wholly owned by its parent, or even shares an identical board of directors with its parent, is normally insufficient for a court to find that the subsidiary is the parent's agent. See, e.g., Schmidt v. Burlington N. & Santa Fe Ry. Co., 605 F.3d 686, 689 (9th Cir. 2010) (citing Kelley v. S. Pac. Co., 419 U.S. 318 (1974)). However, if the subsidiary acts on the parent's behalf, and under the parent's control, the subsidiary may be the agent of the parent, and the employees of the subsidiary may be the sub-agents of the parent. In such circumstances, the acts of the agents or sub-agents may impute criminal liability to the parent. See, e.g., United States v. Johns-Manville Corp., 231 F. Supp. 690, 698 (E.D. Pa. 1963); United States v. Watchmakers of Switzerland Info. Ctr., 134 F. Supp. 710, 711 (S.D.N.Y. 1955).

Mere Instrumentality or Veil Piercing

The general principal that a parent corporation is not liable for the acts of its subsidiaries is inapplicable when a parent treats its subsidiary as a mere instrumentality and uses the subsidiary for a wrongful purpose. In such a situation, courts may pierce the corporate veil and hold the parent accountable for its subsidiary's acts.

Determining whether to pierce the veil is a question of fact. One hundred percent ownership and common directors and officers, even together, are, by themselves, an insufficient basis for piercing the veil. See, e.g., United States v. Bestfoods, 524 U.S. 51 (1998).

Courts consider numerous other issues in the veil-piercing analysis, including the following factors:

- The subsidiary is grossly undercapitalized.
- The subsidiary does business solely with the parent.
- The parent provides financing to the subsidiary.
- The parent and subsidiary consolidate their financial statements.
- The parent uses the subsidiary's assets as its own assets.
- The parent and subsidiary operate physically as a single enterprise.
- The parent and subsidiary fail to observe corporate formalities, including holding required shareholder meetings.

See, e.g., United States v. Jon-T Chemicals, Inc., 768 F.2d 686 (5th Cir. 1985).

Veil piercing for criminal acts remains relatively rare. However, even when a parent and subsidiary are insufficiently intertwined for a court to pierce the veil, subsidiaries or their employees may nonetheless be agents or sub-agents of the parent, resulting in the parent's liability for the criminal acts of its subsidiary's employees.

For guidance on steps that employers can take to help deter criminal activity by its employees and therefore lower the risk of vicarious criminal liability, see Corporate Sentencing and Establishing Effective Compliance Programs below.

The Responsible Corporate Officer Doctrine

Under the Supreme Court-created Responsible Corporate Officer (RCO) doctrine, a corporate officer may be found criminally liable for regulatory offenses even when he or she is unaware of and not involved in the wrongdoing if he or she is in a position of authority regarding the activities giving rise to the illegal conduct and failed to prevent or correct the conduct. United States v. Park, 421 U.S. 658, 672–74 (1975); United States v. Dotterweich, 320 U.S. 277, 284–85 (1943). Penalties under the RCO doctrine can include fines and imprisonment. Meyer v. Holley, 537 U.S. 280, 287 (2003).

When defending against an RCO charge, consider the following two key defenses:

1. The executive could not have prevented or corrected the violation at issue.
2. The executive used extraordinary care and was not able to prevent the violation.

See, e.g., United States v. Wiesenfeld Warehouse Co., 376 U.S. 86, 91 (1964).

ASSESSING POTENTIAL CRIMINAL LIABILITY UNDER DEPARTMENT OF JUSTICE (DOJ) GUIDELINES

Federal prosecutors have broad discretion in deciding whether and how to investigate misconduct, who to charge, and with what crime. Young v. United States, ex rel Vuitton et Fils, S.A., 481 U.S. 787, 807 (1987). The DOJ publishes Principles of Federal Prosecution as part of its U.S. Attorney's Manual to guide prosecutors in exercising their broad charging discretion. USAM, Principles of Federal Prosecution, § 9-27.000 et seq. (USAM). The factors a prosecutor must consider include whether there is a substantial federal interest in prosecuting the crime, whether the person is subject to effective prosecution elsewhere, or whether there exists an adequate non-criminal alternative to prosecutions. USAM, Principles of Federal Prosecution, § 9-27.220.

In determining whether there is a substantial federal interest in prosecuting a particular crime, prosecutors must consider:

- Federal law enforcement priorities
- The nature and seriousness of the offense
- The deterrent effect of the prosecution
- The person's culpability
- The person's criminal history
- The person's willingness to cooperate
- The victim's views –and–
- The likely sentence

USAM Principles of Federal Prosecution, § 9-27.230.

Similar guidance exists for determining whether and how to charge organizations that are being investigated for misconduct. Prosecutors must consider:

- The nature and seriousness of the offense
- The pervasiveness of wrongdoing within the corporation
- The corporation's history of similar misconduct
- The corporation's willingness to cooperate
- The existence and effectiveness of the corporation's compliance program
- Whether the misconduct was timely and voluntarily disclosed
- Remedial actions
- Collateral consequences of a criminal charge to shareholders, employees, and others who are not culpable
- The adequacy of civil or regulatory remedies –and–
- The adequacy of the prosecution of individuals

USAM Principles of Federal Prosecution of Business Organizations, § 9-28.300.

In addition to the U.S. Attorney's Manual, DOJ leadership periodically will issue guidance memoranda establishing policy. Most recently, Attorney General Jeff Sessions issued a "Department Charging and Sentencing Policy" requiring federal prosecutors to charge and pursue "the most serious readily provable offense" and requiring U.S. Attorney approval for any deviations from that policy.

The interplay of these charging guidelines become evident when a prosecutor is considering corporate misconduct involving individual officers and employees of a company. The USAM provides that "prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. … Imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing." USAM Principles of Federal Prosecution of Business Organizations, § 9-28.210.

At the turn of the twenty-first century, corporate charging focused largely on remediating misconduct within organizations. The post-Enron culture, along with the advent of Sarbanes-Oxley, led to an emphasis of rehabilitation over punishment, and corporate prosecutions during those years frequently involved many deferred prosecution or non-prosecution agreements along with significant fines. After the financial crisis that began in 2008, individual accountability for corporate wrongdoers became a more significant priority.

Yates Memo

In 2015, the DOJ issued a memorandum entitled "Individual Accountability for Corporate Wrongdoing," commonly referred to as the "Yates Memo." USAM Principles of Federal Prosecutions, § 1-12.000. The Yates Memo reiterated the Department's longstanding focus on prosecuting culpable individuals, but sought to impose some of the responsibility on the corporations within which the wrongdoers worked. The Yates Memo required companies that were seeking leniency in charging negotiations with the DOJ to identify and provide evidence against those company officials who committed the criminal acts for which the company was being investigated.

In announcing the policy, then-Deputy Attorney General Sally Yates stated, "it is our obligation at the Justice Department to ensure that we are holding lawbreakers accountable regardless of whether they commit their crimes on the street corner or in the boardroom. In the white-collar context, that means pursuing not just corporate entities, but also the individuals through which these corporations act."

The Yates Memo lists six steps prosecutors must follow in the case of corporate wrongdoing:

1. Require companies seeking cooperation credit or leniency to identify all individuals responsible for the misconduct at issue, regardless of their stature in the company
2. Focus on individual wrongdoers from the outset of any investigation
3. Coordinate with civil division prosecutors to assess financial penalties for individuals
4. Decline to provide immunity from prosecution for individual officers as part of a plea deal
5. Refrain from settlement with a company without a specific approved plan for individual prosecutions – and–
6. File civil action

When Attorney General Sessions took office, he indicated in an April 2017 speech that the Justice Department would continue to emphasize the importance of holding individuals accountable for corporate misconduct because, in his view, "it is not merely companies, but specific individuals, who break the law."

In 2017, Deputy Attorney General Rod Rosenstein announced during a speech before the Heritage Foundation that the Yates Memo is "under review." As of Summer 2018, no changes to the policies and key steps outlined in the Memorandum have been announced. See "DAG Rosenstein: Changes Coming 'in the Near Future' to Yates Memo."

CRIMINAL LIABILITY UNDER FEDERAL EMPLOYMENT LAWS

This section addresses potential criminal liability under certain key employment laws.

Fair Labor Standards Act (FLSA)

This subsection provides a brief overview of the FLSA and addresses potential remedies under it, including criminal penalties.

General Provisions

Congress enacted the Fair Labor Standards Act (FLSA) in 1938 to establish standards for federal minimum wage, maximum hours and overtime pay, and recordkeeping for full-time and part-time employees in the private sector and in federal, state, and local governments, except those exempt from coverage under 29 U.S.C. § 213. Under the current law, a covered employer must pay a minimum wage of $7.25 an hour, 29 U.S.C. § 206(a)(1)(C), and pay wages "at a rate not less than one and one-half times the regular rate" for a work week longer than 40 hours. 29 U.S.C. § 207(a)(1). An individual employee, supervisor, or any other agent of the employer may not be held personally liable under the FLSA. Rose v. G.UB.MK Constr., 1999 U.S. App. LEXIS 13307, at *4 (6th Cir. June 10, 1999). In addition, an employer must make, keep, and preserve records of wages, hours, and other conditions and practices of employment for all employees. 29 U.S.C. § 211(c).

The FLSA also prohibits employers from employing minors under conditions that constitute oppressive child labor. 29 U.S.C. § 212(c). The FLSA defines "oppressive child labor" as (1) the employment of a child under the age of sixteen years by an employer other than a parent or a guardian in any occupation or (2) the employment of a child below the age of eighteen "in any occupation which the Secretary of Labor shall find and by order declare to be particularly hazardous for the employment of children between such ages or detrimental to their health or well-being[.]" 29 U.S.C. § 203(l). In certain cases, a producer, manufacturer, or dealer may be prosecuted under the FLSA for delivering or shipping in commerce any goods produced in the United States "in or about which within thirty days prior to the removal of such goods therefrom any oppressive child labor has been employed[.]" 29 U.S.C. § 212(a).

For more information on the FLSA, see Wage and Hour practice notes page.

Equal Pay Provisions

Under the federal Equal Pay Act, which is part of the FLSA, an employer may not discriminate between employees on the basis of sex in payment of wages "at a rate less than the rate at which he pays wages to employees of the opposite sex" for equal work requiring "equal skill, effort, and responsibility, and which are performed under similar working conditions[.]" 29 U.S.C. § 206(d)(1). Additionally, any employer that violates this provision may not reduce the wage rate of any employee to comply with the provision. 29 U.S.C. § 206(d)(1). An exception to the provision applies where payment of wages is made pursuant to "(1) a seniority system; (2) a merit system; (3) a system which measures earnings by quantity or quality of production; or (4) a differential based on any other factor other than sex[.]" 29 U.S.C. § 206(d)(1).

For information on the Equal Pay Act, see Equal Pay Act: Key Compliance Issues and Pay Equity Audits: Best Practices. See also 6 Larson on Employment Discrimination § 107.01—Equal Pay Act: Overview.

Retaliation Provisions

The FLSA also contains a retaliation provision. Where there has been an alleged violation of any of the provisions of the FLSA, it is unlawful for an employer "to discharge or in any other manner discriminate against any employee because such employee has filed any complaint or instituted . . . any proceeding under or related to [the FLSA], or has testified or is about to testify in any such proceeding, or has served or is about to serve on an industry committee[.]" 29 U.S.C. § 215(a)(3). Courts have interpreted the requirement for "filing a complaint" broadly to include an employee's oral complaint to the employer. See, e.g., Kasten v. Saint-Gobain Performance Plastics Corp., 563 U.S. 1, 17 (2011) (holding that an employee may bring a claim for retaliation under Section 215(a)(3) based on an oral complaint to the employer for an FLSA violation).

For more information on FLSA retaliation issues, see Retaliation Claim Avoidance under the FLSA.

Administrative Enforcement

To administer and enforce the provisions of the FLSA, Congress established the Wage and Hour Division of the U.S. Department of Labor. 29 U.S.C. § 204(a). Under the direction of the Wage and Hour Division Administrator, the Wage and Hour Division has broad authority to (1) "investigate and gather data regarding the wages, hours, and other conditions and practices of employment;" (2) "enter and inspect such places and such records;" and (3) "question such employees, and investigate such facts, conditions, practices, or matters" necessary or appropriate to determine whether there are any violations of the FLSA or to aid in the enforcement thereof. 29 U.S.C. § 211(a).

Penalties for Violation of FLSA

Any person who willfully violates any provision of the FLSA may be subject to criminal penalties, including a fine of not more than $10,000, or for an individual with a prior conviction under this subsection, imprisonment for not more than six months or both. 29 U.S.C. § 216(a); see also McLaughlin v. Richland Shoe Co., 486 U.S. 128, 133 (1988) (defining "willful" as either knowing or "show[ing] reckless disregard for the matter of whether its conduct was prohibited by statute"). Liability for violating provisions of the FLSA also can take the form of civil penalties. 29 U.S.C. § 216(b), (e). An employer may be liable to the affected employee or employees for unpaid minimum wages, unpaid overtime compensation, an additional amount in liquidated damages, as well as legal or equitable relief, including employment, reinstatement, and promotion. 29 U.S.C. § 216(b).

For more information on remedies under the FLSA, see 1 Wages & Hours: Law and Practice § 9.04—Remedies Under the Fair Labor Standard Act. See also 6 Larson on Employment Discrimination § 109.01—Overview of [Equal Pay Act] Remedies Against Employers.

Occupational Safety and Health Act (OSH Act)

This subsection provides a brief overview of the OSH Act and addresses potential remedies under it, including criminal penalties.

General Provisions

The Occupational Safety and Health Act of 1970 (OSH Act) is a federal law that regulates occupational safety and health standards for most private sector employers and some public sector employers in federal government. 29 U.S.C. § 654. The main goals of the OSH Act are to protect employees from unsafe workplaces, including exposures to toxic chemicals, deadly safety hazards and diseases, and to provide training programs to increase occupational safety and health. 20 U.S.C. § 651. To carry out these goals, the OSH Act authorizes the Secretary of Labor to enter any place of employment and to inspect and investigate at reasonable times, within reasonable limits, and in a reasonable manner "any such place of employment and all pertinent conditions, structures, machines, apparatus, devices, equipment, and materials therein, and to question privately any such employer, owner, operator, agent, or employee." 29 U.S.C. § 657(a)(1)–(2). To assist in the inspection and investigation, the Secretary of Labor may issue a subpoena requiring the attendance and testimony of witnesses and the production of evidence under oath. 29 U.S.C. § 657(b).

For more information on the OSH Act, see OSH Act Requirements, Inspections, Citations, and Defenses.

Administrative Enforcement

The OSH Act also created several federal administrative agencies to regulate and enforce provisions of the OSH Act and the rules and regulations promulgated thereof, including the Occupational Safety and Health Administration (OSHA), Occupational Safety and Health Review Commission, and the National Institute for Occupational Safety and Health. OSH Act protections extend to public sector employers in some local and state governments through OSHA-approved state plans, but these are regulated and enforced by designated state agencies rather than the federal OSHA. 29 U.S.C. § 667.

Penalties

Any violation of rules, order, or regulation promulgated under the OSH Act, including willful and repeated violations, will result in "citation to the employer" or "notice in lieu of a citation with respect to the de minimis violations which have no direct or immediate relationship to safety or health." 29 U.S.C. § 658(a). Such employer will also be assessed a civil penalty for each violation or for failure to correct the violation. 29 U.S.C. § 666(a)–(d).

Under circumstances where an employer willfully violates the OSH Act and any standards, rules, orders, or regulations promulgated thereunder, and such violation causes death to any employee, the employer will be subject to criminal liabilities upon conviction, including "a fine of not more than $10,000 or by imprisonment for not more than six months, or by both," or "a fine of not more than $20,000 or by imprisonment for not more than one year, or by both" for any subsequent convictions. 29 U.S.C. § 666(e); Am. Recycling & Mfg. Co., Inc. v. Sec. of Labor, 676 F. App'x 65, 71 (2d Cir. 2017) (defining "willful" as violations "'done either with an intentional disregard of, or plain indifference to,' the safety regulation"). It is also unlawful for any unauthorized person to give advance notice of any inspection or for any person to knowingly make "any false statement, representation, or certification in any application, record, report, plan, or other document filed or required to be maintained" under the OSH Act. 29 U.S.C. § 666(f), (g). Both offenses are punishable by fine or by imprisonment, or both. 29 U.S.C. 666(f), (g).

For more information on remedies under the OSH Act, including criminal penalties, see OSH Act Requirements, Inspections, Citations, and Defenses — OSHA Citations and Penalties.

No-Poaching and Wage Fixing Claims

Criminal liability in the employment context also can arise in connection with no-poaching and wage fixing claims. No-poaching agreements are agreements between companies to cease hiring each other's employees. Wage fixing agreements are agreements between companies to set or limit the wages for particular positions. These agreements are per se illegal under federal antitrust laws. For detailed guidance on no-poaching and wage fixing claims and information on potential criminal liability attached to such claims, see Antitrust Concerns in No-Poaching, Wage-Fixing, and Non-compete Agreements.

CORPORATE SENTENCING AND ESTABLISHING EFFECTIVE COMPLIANCE PROGRAMS

Often, a company under investigation for criminal violations seeks to ameliorate potential penalties by demonstrating to prosecutors that it had in place an effective compliance program. The U.S. Sentencing Commission promulgated the Organizational Sentencing Guidelines in Chapter 8 of the U.S. Sentencing Guidelines (Guidelines) to rectify inequities resulting from inconsistent sentencing. Notably, the Guidelines explicitly seek to alleviate the harsh impact of the respondeat superior doctrine by allowing a company to show that it had an effective compliance program in place to deter or prevent misconduct by company employees or officers. See Federal Sentencing Guidelines Manual (USSG), § 8B2.1 (U.S. Sentencing Comm'n 2016). An effective compliance program can serve to reduce significantly the fines that a convicted organization must pay.

The concept of an effective compliance program to deter criminal conduct is also present in the Federal Prosecution of Business Organizations chapter of the U.S. Attorney's Manual. The "effective program" described in both this document and the Guidelines is one of the primary tools, together with self-disclosure and cooperation, that enables a company to seek leniency from the DOJ at sentencing or, perhaps more importantly, in charging decisions. Indeed, the existence of an effective compliance program remains both a key driver in corporate behavior and a key factor considered in charging and leniency decisions.

In addition to often mandatory restitution to the victims of the offense and forfeiture of ill-gotten gains, organizational sentences can include hefty fines. The appropriate fine is determined by the detailed formulas set out in the Organizational Sentencing Guidelines. See USSG § 8 (U.S. Sentencing Comm'n 2016). While the Guidelines initially were mandatory, in 2005, the U.S. Supreme Court in United States v. Booker, 543 U.S. 220 (2005), held that a mandatory guidelines rubric was unconstitutional and made the Guidelines advisory only. Later cases determined that courts must consider the Guidelines and calculate a sentencing score, but courts may vary from the Guidelines if the facts of the case justify the variance. Gall v. United States, 552 U.S. 38 (2007) (the district court should begin all sentencing proceedings by correctly calculating the applicable guideline range, and that "to secure nationwide consistency, the Guidelines should be the starting point and the initial benchmark"); see also USSG § 1B1.1(a)-(c) (Application Instructions) (U.S. Sentencing Comm'n 2016).

There is little court involvement in the application of the Guidelines in the context of a corporate sentence. The vast majority of those cases settle out of court through negotiation between the parties, with the fulcrum of the negotiations often being the fine that the company will need to pay upon conviction. Whether there is a negotiated plea deal or a conviction, the Guidelines still apply to determine the appropriate fine.

Under the Guidelines, organizations are entitled to receive a sentencing credit if they can demonstrate that they have an effective compliance program. That credit entitles organizations to a decrease in their "culpability score." See USSG § 8C2.5(f)(1) (U.S. Sentencing Comm'n 2016). Calculating a fine range under the Guidelines requires that the court first determine the base offense level for the crime and then apply the culpability score. The culpability score considers such variables as the size of the company, the extent of the misconduct, and the financial loss caused by the misconduct and awards points that increase the score. Having an effective compliance program subtracts points from the culpability score, which can result in significantly lower fines.

Building Blocks for an Effective Compliance Program

The Guidelines specifically describe the basic building blocks that must be present for a company to be viewed as having an effective compliance program and thus achieve the maximum sentencing credit. These include:

- Written standards and procedures to prevent and detect criminal conduct
- Knowledgeable and resourced board and management, with dedicated compliance personnel

- Due diligence on personnel with substantial authority to bind the company
- Regular communication and effective training
- Monitoring and auditing for criminal conduct, periodic evaluation of the compliance program, and the ability of employees to report misconduct without retaliation
- Consistent enforcement throughout the organization –and–
- Response to misconduct and modifications to program as needed

See USSG § 8B2.1(b) (U.S. Sentencing Comm'n 2016).

Even if an organization has an effective compliance program, it will not be able to receive the three-point reduction in its culpability score if it delayed in reporting the offense to the appropriate governmental authorities, USSG § 8C2.5(f)(2) (U.S. Sentencing Comm'n 2016), or where a high-level official of the company participated in, condoned, or was willfully ignorant of the offense. See USSG § 8C2.5(f)(3)(A) (U.S. Sentencing Comm'n 2016). There are circumstances where, despite the involvement of a high-level company official in the charged crime, the company can still receive the three-point reduction in its culpability score, including the following:

- The individual with responsibility for the ethics and compliance program reports directly to the board of directors or its audit committee.
- The compliance program detected the offense before its discovery by outside auditors.
- The organization promptly reported the offense to the authorities.
- No officer within the compliance organization participated in, condoned or was willfully ignorant of the offense.

See USSG § 8C2.5(f)(3)(C)(i-iv) (U.S. Sentencing Comm'n 2016).

Taken together, the Guidelines and the Principles of Federal Prosecution of Business Organizations provide a high-level roadmap of the key components of an effective compliance program. For example, the Guidelines provide that the company must promote "an organizational culture that encourages ethical conduct and a commitment to compliance with the law" and that the organization's "governing authority" be "knowledgeable about the content and operation of the compliance and ethics program and . . . exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program." See USSG § 8B2.1(a)(2), (b)(2)(A) (U.S. Sentencing Comm'n 2016).

In February 2017, the DOJ's Fraud Section released an evaluation document listing "important topics" and questions with which DOJ would assess corporate compliance programs. The evaluation document poses a series of questions that DOJ encourages compliance professionals to consider as they design their compliance programs, and which in turn DOJ prosecutors will consider as they evaluate the effectiveness of the compliance program of a company under investigation. It is a useful guide to the critical thinking in which DOJ expects corporate leaders to engage to drive common sense, analytical, and data-driven approaches to evaluating compliance risks and creating policies that address those risks.

In addition to mitigating fines, an effective compliance program can help avoid other significant negative consequences, including expanded and costly investigations, civil and criminal prosecution, fines and disgorgement, the imposition of a compliance monitor, shareholder litigation, and reputational damage. Of course, even the best-designed, data-driven, and fully supported compliance program will not assure full compliance with the law all of the time. But understanding the elements that the DOJ expects a company to consider in designing compliance policies and programs, and self-evaluating against those criteria, is the safest way to implement a truly effective compliance program that, if need be, can help a company to achieve a lower criminal fine than the Guidelines would ordinarily require.

CIVIL LIABILITY IN SEC ENFORCEMENT ACTIONS

Officers and directors of publicly traded corporations are subject to the federal securities laws, principally the Securities Act of 1933 (Securities Act), as amended, 15 U.S.C. § 77a et seq. and the Securities Exchange Act of 1934 (Exchange Act), as amended, 15 U.S.C. § 78a et seq. The Exchange Act authorizes the Securities and Exchange Commission (SEC) to institute administrative and civil proceedings and seek monetary and injunctive relief from culpable officers and directors for primary violations of securities laws. Additionally, the SEC can impose secondary liability on officers and directors via the control person theory of liability.

Control Person Theory of Liability

Both the Securities Act and the Exchange Act impose secondary liability on “controlling persons” for violations of securities laws committed by persons under their control. See 15 U.S.C. § 77o; 15 U.S.C. § 78t(a); see also 15 U.S.C. § 78t(b). Generally, “control” for these purposes is held by any officer, director, or employee of a public company who possesses, directly or indirectly, the power to “direct or cause the direction of the management and policies” of the person or entity that is liable for a violation of the securities laws. This may include, for example, CEOs, CFOs, CCOs, board members, or other senior officers and directors, but may also include, for example, shareholders exercising control over an entity. See generally 15 U.S.C. § 78t(a) and 17 C.F.R. § 230.405.

Section 15 of the Securities Act (15 U.S.C. § 77o)

Section 15 of the Securities Act provides that any person who controls another person who commits a violation under Sections 11 or 12 of the Securities Act will be jointly and severally liable for the wrongful conduct “unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist.” Section 11 creates civil liability for false registration statements and Section 12 creates liability for information included in prospectuses and communications. Control liability under Section 15 only applies to these two specific violations, while Section 20(a) of the Exchange Act applies to a range of violations, notably those involving Section 10(b) of the Exchange Act, which is the primary antifraud provision, and is therefore used much more frequently.

Section 20(a) of the Exchange Act (15 U.S.C. § 78t)

Section 20(a) of the Exchange Act provides that every person who indirectly or directly controls another person found liable for a securities violation under the Exchange Act is jointly and severely liable for that same conduct, “unless the controlling person acted in good faith and did not directly or indirectly induce” the act(s) constituting the violation. 15 U.S.C. § 78t(a). Originally, circuit courts were divided on whether the SEC had statutory authority to bring claims under Section 20(a). The Dodd-Frank Act clarified any confusion by amending Section 20(a) to grant clear authority to the SEC to bring monetary and injunctive claims against corporate officers and directors for violations committed by their subordinates. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 929P(c) (2010).

Court Interpretation of Section 15 and Section 20(a)

Courts have generally treated Section 20(a) and Section 15 as “parallel provisions” whose “terms are interpreted in the same manner.” See, e.g., In re Glob. Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 349 (S.D.N.Y. 2004). The major exception to this general rule is with respect to Section 20(a) and the requirements necessary to demonstrate “control” by the officer or director with respect to the underlying primary violation. A minority of circuits (Second, Third, and D.C.) require a heightened showing. These circuits will not hold a controlling person liable if plaintiff fails to demonstrate that he or she had “culpable participation” in the alleged primary violation(s). See, e.g., Carpenters Pension Trust Fund of St. Louis v. Barclays PLC, 750 F.3d 227, 236 (2d Cir. 2014). These courts reason that Congress did not intend for controlling persons to be liable for the fraudulent activities of others, except in circumstances where the controlling persons “were in some meaningful sense culpable participants in the fraud.” See Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 485 (3d Cir. 2013). Courts have found culpable participation where the controlling person either had “knowing or substantial participation in the wrongdoing or inaction with the intent to further the fraud or prevent its discovery.” In re Merck & Co., 2015 U.S. Dist. LEXIS 62983, at *110–11 (D. N.J. May 13, 2015) (citing Rochez Bros. v. Rhoedes, 527 F.2d 880, 890 (3d Cir. 1975)).

Similarly, district courts in the D.C. Circuit require culpable participation because without some evidence of malfeasance any director of a public company could be subject to liability due to their exercise of some degree of control over its policies and employees. See, e.g., Freeland v. Iridium World Communications., Ltd., 545 F. Supp. 2d 59, 81–84 (D.D.C. 2008).

A majority of circuits (Fourth, Fifth, Seventh, Eighth, Ninth, Tenth, and Eleventh) require a lesser showing, and have adopted some form of a “potential control” standard. This standard does not require the controlling person to exercise actual control over the specific acts or omissions that gave rise to the primary violation of securities laws. Instead, it requires only that the individual exercised control over the general operations of the business that included the primary violation, and possessed the power to exercise control over the transaction or activity giving rise to the violation. See, e.g., In re Mut. Funds Inv. Litig., 566 F.3d 111, 129–30 (4th Cir. 2009); Laperriere v. Vesta Ins. Group, 526 F.3d 715, 723–25 (11th Cir. 2008).

Regardless of the standard imposed, Section 20(a) of the Exchange Act provides an affirmative defense to an officer or director who (1) “acted in good faith” and (2) “did not directly or indirectly induce” the act(s) constituting the violation. 15 U.S.C. § 78t(a). Most courts agree that a person acted in good faith if he or she did not act with recklessness or scienter. See, e.g., Laperriere v. Vesta Ins. Group, 526 F.3d 715, 723–25 (11th Cir. 2008); Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000). Courts, however, disagree over the interpretation of “did not directly or indirectly induce” the violation. Some courts interpret the clause broadly to mean that a controlling person must have done “enough to prevent the violation,” which requires him to have “exercised due care in his supervision of the [primary] violator’s activities” by “maintain[ing] and enforc[ing] a reasonable and proper system of supervision and internal controls.” SEC v. First Jersey Sec. Inc., 101 F.3d 1450, 1473 (2d Cir. 1996). Other courts have noted that Section 20(a)’s legislative history envisioned a narrower reading focusing on a controlling person who actually caused or persuaded the underlying violation to occur. See Rochez Bros. v. Rhoades, 527 F.2d 880, 885 (3d Cir. 1975) (citing H.R. Rep. No. 73-85, at 5 (1933); H.R. Rep. No. 73-152, at 26 (1933)).

Ways to Avoid or Reduce Risk of Control Person Liability in SEC Enforcement Actions

Corporate officers and directors can mitigate their potential exposure to control person enforcement actions by encouraging a corporate culture of compliance and implementing a robust system of supervision and internal controls. To encourage a corporate culture of compliance, officers and directors should exhibit the appropriate “tone at the top” at all times. This means ensuring that compliance with applicable laws, as well as internal policies, is not just encouraged, but mandatory and practicing that compliance themselves.

Additionally, officers and directors should implement a reasonable and proper system of supervision and internal controls to prevent securities violations before they occur. Not only is this good practice for the corporation as a whole, but it strengthens an affirmative defense against a future control liability claim. Officers and directors should also ensure that the company provides appropriate training and guidance that is suitably tailored to the nature of their business.

The first step in implementing a system of supervision and internal controls is often via a risk assessment to identify potential areas of liability. The risk assessment can serve as a guide for targeted trainings, updates to policies and procedures, and future assessments of the effectiveness of the controls that were implemented. Secondly, the company should revisit and update the supervision and internal controls on a regular basis and monitor when the SEC makes significant changes to relevant regulations and guidelines.

Corporate officers and directors should also examine their Director & Officer (D&O) insurance to ensure that it adequately covers liability for control person claims. They should consider not just the expenses of defending these claims, but also any potential fines or penalties imposed for their control person liability.

CIVIL LIABILITY IN SHAREHOLDER DIRECT AND DERIVATIVE ACTIONS

Directors, officers, and corporations often are subject to direct and derivative actions brought by shareholders of the corporation who bring an action in either their personal capacity or on behalf of the corporation, respectively. In particular, direct actions involve the enforcement of a right specific to the particular shareholder bringing suit. Derivative actions involve the enforcement of a right belonging to the corporation that the corporation has declined to assert.

Delaware is the leading domicile for United States and international corporations and has the most established and comprehensive statutes and case law governing corporations. In determining whether a shareholder action is direct or derivative, Delaware courts apply a two-part test: "(1) who suffered the alleged harm (the corporation or the suing stockholder, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004); see also Yudell v. Gilbert, 99 A.D.3d 108, 114, 949 N.Y.S.2d 380, 384 (1st Dep't 2012). In a derivative action, a shareholder bringing suit on behalf of the corporation must first demonstrate "demand refusal" or "demand futility." Under demand refusal, plaintiffs must demonstrate that they have demanded the board to sue on behalf of the corporation, which the board has rejected. Alternatively, under demand futility, the plaintiff must demonstrate that a demand on the board would be futile. Quadrant Structured Prods. Co., Ltd. v. Vertin, 102 A.3d 155, 181–82 (Del. Ch. 2014). See also Del. Ch. Ct. R. 23.1. Delaware courts make these determinations independently. A plaintiff's self-classification of an action (as a direct or derivative claim) is not binding on the court. See, e.g., Allen v. El Paso Pipeline GP Co., L.L.C., 90 A.3d 1097, 1105 (Del. Ch. 2014).

Business Judgment Rule Defense and the Entire Fairness Doctrine

The business judgment rule is a standard of judicial review that provides wide latitude to directors in handling the business and affairs of the corporation. The business judgment rule is a rebuttable presumption under which a reviewing court will not engage in an evaluation of the merits of (or second-guess) the directors' or officers' decision. However, the protections of the business judgment rule apply only where directors and officers who are disinterested and independent make a business decision on an informed basis, in good faith, with due care, and in the honest belief that they took the action in the best interests of the corporation. See Gantler v. Stephens, 965 A.2d 695, 705–06 (Del. 2006). Plaintiffs may thus rebut the presumption by proving that the directors or officers breached any one of the triads of their fiduciary duty of good faith, loyalty, or due care. See, e.g., Liquidation Tr. of Hechinger Inv. Co. of Del., Inc. v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co. of Del., Inc.), 327 B.R. 537, 549 (D. Del. 2005).

If a plaintiff successfully rebuts the presumption, the burden shifts to the directors and officers to prove the "entire fairness" of the transaction. Under the entire fairness doctrine, directors "must establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). In other words, this high standard requires the corporation to prove both that the process that was followed and the price that was achieved were fair to the stockholders of the corporation. For more information on the business judgment rule and the entire fairness doctrine, see Fiduciary Duties of Board of Directors.

Key Types of Derivative Actions

Directors, officers, and corporations can be susceptible to shareholder derivative suits in a variety of contexts, including in takeovers, sales, and other direct transactions, in connection with their disclosure and reporting obligations, in communications and dealings with their company's shareholders, and in the offering or issuance of securities or bonds. See, e.g., In re Paxson Commc'n Corp. v. S'holder Litig., 2001 Del. Ch. LEXIS 95, at *27 (Del. Ch. July 10, 2001) (involving a shareholder derivative suit against directors and officers for breach of fiduciary duty in connection with a potential acquisition). A claim for breach of fiduciary duty and waste can also arise in connection with the approval of an executive compensation package. See, e.g., In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 34 (Del. 2006) (asserting claims for breaches of fiduciary duty and waste in a derivative action against a former president of the corporation and the board for a $130 million severance payout). Liability can also arise in the context of shareholder derivative suits brought against corporate officers and directors for self-interested transactions. See, e.g., In re Riverstone Nat'l, Inc. S'holder Litig., 2017 Del. Ch. LEXIS 111, at *23 (Del. Ch. July 28, 2016) (involving a shareholder derivative action brought against directors arising from allegations of self-interest in connection with a transaction).

#MeToo Movement Litigation

Recently, in the wake of the #MeToo Movement, companies have experienced an increased risk of exposure to derivative actions by shareholders for breaches of fiduciary duty and waste of corporate assets arising from allegations that the company's officers and directors had actual knowledge of or were willfully blind to sexual misconduct and intentionally concealed the misconduct from shareholders, or misused corporate assets and legal resources to settle claims against alleged harassers. See, e.g., City of Monroe Employees' Ret. Sys. v. Rupert Murdoch et al., No. 2017-0833-AGB, complaint filed (Del. Ch. Nov. 20, 2017) (shareholder derivative action brought against the officers and directors of Twenty-First Century Fox, Inc. arising from sexual harassment allegations against Roger Ailes and Bill O'Reilly); Norfolk Cty. Ret. Sys. v. Stephen A. Wynn et al., No. A-18-769062-B, complaint filed (Nev. Dist. Ct., Clark Cty. Feb. 6, 2018) (shareholder derivative action brought against board of Wynn Resorts Ltd. for payment of excessive compensation to and failure to prevent misconduct by the company's founder, Stephen Wynn, who had been accused of sexual harassment and assault). For more information on claims in the wake of the #MeToo Movement, see Attorneys Predict Wave Of #MeToo Investor Suits and Zero-Tolerance In #MeToo Era May Be Perilous For Employers.

Strategies to Decrease Risk of Derivation Actions

To protect against shareholder derivative actions, there are several steps that directors, officers, and corporations can take, including:

- Ensuring that shareholder votes are fully informed, disinterested, and non-coerced
- Acting in the corporation's interests and avoiding even the appearance of self-dealing
- Providing greater transparency through disclosures when seeking shareholder approval –and–

- Disclosing any perceived or actual conflicts of interest for directors and officers

A robust compliance culture is useful in decreasing liability in civil cases as well as in criminal and regulatory matters. As noted above, this entails:

- Implementing programs, processes, and controls to identify, investigate, and address potential wrongdoings by officers, directors and employees, and robustly following such processes
- Retaining independent legal and financial advisors
- Creating special committees to conduct impartial internal investigations –and–
- Adopting and strictly enforcing no-retaliation policies and practices

Additionally, companies should provide up-to-date training programs, establish ethical standards, and disclose any material information regarding the company to its shareholders. Finally, directors and officers should ensure that the company's D&O insurance provides coverage for defending derivative lawsuits, and that the company's bylaws or certificate of incorporation provide for advancement of expenses and indemnification in appropriate circumstances.

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Jodi Avergun is Chair of the firm's White Collar Defense and Investigations Group. Her practice focuses on representing corporations and individuals in criminal and regulatory matters involving, among other things, the Foreign Corrupt Practices Act, securities enforcement, health care, and general white collar matters. Jodi has successfully represented both companies and senior executives in internal investigations, matters before regulatory bodies including the SEC and the U.S. Drug Enforcement Administration, and in civil and criminal matters in federal court. She has also designed and implemented compliance programs for a variety of her clients.

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Lex Urban has extensive experience leading domestic and cross-border internal investigations for global corporations, financial institutions and boards of directors in connection with potential violations of the Foreign Corrupt Practices Act, the Bank Secrecy Act and securities laws/regulations. These representations have included conducting interviews of senior level executives, board members, and directors; and frequently communicating with and advocating before the DOJ and SEC in the context of voluntary disclosures and responses to formal inquiries and subpoenas. Lex's global practice has included a broad range of alleged and suspected misconduct around the world, including in Europe, Asia, Africa, Australia, as well as within the United States. Additionally, Lex regularly represents corporate-level executives in white collar matters before the SEC, DOJ and other government agencies.

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