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SEC's Expanded Arsenal: Control Person Liability

Law360, New York (September 02, 2009) -- Under the recent leadership of Chairman Mary Schapiro and Enforcement Director Robert Khuzami, the U.S. Securities and Exchange Commission Enforcement Division has introduced a series of new enforcement initiatives.

One of the more striking of these initiatives is the expanded use of Section 20(a) of the Securities Exchange Act of 1934 (the “Exchange Act”), the control person liability provision of the Exchange Act.

During the summer of 2009, the SEC brought two settled enforcement actions in which it sued a defendant based solely on the control person liability provisions of the federal securities laws.

On July 31, 2009, the SEC charged two officers of Nature’s Sunshine Products Inc. (“NSP”) under the control person liability provision of the Exchange Act for violations by the company of the internal controls and books and records provisions of the Exchange Act.[1]

The SEC alleged that Faggioli (as president and CEO of NSP) and Huff (as CFO of NSP) had failed adequately to supervise NSP’s personnel who were directly or indirectly responsible for making and keeping its books and records and maintaining a system of internal controls sufficient to have provided reasonable assurance that the registration of certain products was adequately monitored.

Faggioli and Huff each consented to the entry of a final judgment that would enjoin him from future violations of the books and records and internal controls provisions of the Exchange Act and would order him to pay a civil penalty of $25,000.[2]

One week later, the SEC alleged that Maurice “Hank” Greenberg, the former Chairman and CEO of AIG, had violated Section 20(a) of the Securities Exchange Act of 1934 and was liable as a control person. [3]

Although the SEC alleged that Greenberg was a “culpable participant” in AIG’s violations of the antifraud, reporting, internal controls and books and records provisions of the Exchange Act, the SEC did not charge Greenberg with either violating or aiding and abetting AIG’s violations of the securities laws.

Greenberg consented to the entry of a final judgment enjoining him from violating those provisions of the Exchange Act and directing him to pay a penalty of $7.5 million and disgorgement of $7.5 million.

These actions suggest a new aggressiveness by the SEC against individuals who did not act either knowingly or with scienter.[4]

Enforcement Action Under Control Person Liability Provision

In general, the SEC can obtain civil penalties against a person only if the person violated or aided and abetted a violation of the federal securities laws, is a regulated entity, is associated with a regulated entity, or participated in a penny stock offering. See Sections 21(d) and 21B of the Exchange Act.

Charging control person under Section 20(a), however, substantially broadens the ability of the commission to seek civil penalties.

Section 20(a) provides that a control person is jointly and severally liable with and to the same extent as the controlled person to any person to whom the controlled person is liable subject to certain conditions:

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

The Courts of Appeals are divided on whether the SEC can bring an enforcement action under these provisions. Compare SEC v. J. W. Barclay & Co. Inc., 442 F.3d 834, 843 n. 14 (3rd Cir. 2006) (stating that Section 20(a) does not provide a basis for imposing derivative liability on the control person for the conduct of the controlled person) and SEC v. First Jersey Sec. Inc., 101 F.3d 1450 (2d Cir. 1996) (holding that Section 20(a) applied to SEC enforcement actions).

Under Section 21(d) of the Exchange Act, the SEC may seek, and a court may impose, civil penalties against a person who violated the Exchange Act. Section 21(d)(3).

In addition, under Section 21(B), the commission may impose penalties in an administrative proceeding against a regulated entity (or person associated with a regulated entity) that willfully violated the federal securities laws and any person who participated in a penny stock offering who willfully violated the federal securities laws. Section 21B(a).

In general, a violation of the Exchange Act requires a state of mind more culpable than negligence. Thus, absent control person liability, the SEC generally cannot obtain a penalty from a person absent a finding that the person's state of mind was more culpable than negligence.

If the SEC can maintain an action under Section 20(a) then the SEC might be able to obtain civil penalties from individuals as to whom civil penalties otherwise could not be imposed.

Although the case law regarding the application of Section 20(a) to SEC enforcement actions is limited, courts have long have struggled with what standard of conduct is required to support a private action pursuant to Section 20(a).

Many courts have held that a plaintiff can maintain a private action under Section 20(a) without alleging any misconduct by the alleged control person. J. Mammel and R. Malionek, "Elusive Standard to Plead §20(a) Control Person Liability," New York Law Journal (Mar. 5, 2007), available at www.lw.com/upload/pubContent/_pdf/pub1822_1.pdf.

In these courts, a control person liability claim can be maintained without any allegation that the control person acted negligently or in bad faith.

While other courts, including the U.S. Court of Appeals for the Second Circuit, have required a plaintiff to allege "culpable participation," such courts disagree "as to precisely what conduct, beyond negligence, 'culpable participation' entails." In re Alstom, 406 F.Supp.2d 433, 490 (S.D.N.Y. 2005). See also J. Mammel and R. Malionek, supra at 2.

It thus might be possible for the SEC to maintain a control person liability claim in the courts based on a claim of simple negligence. Indeed, the Nature's Sunshine action appears to be such a case.

The potential power of a Section 20(a) charge is illustrated by Nature's Sunshine. Nature's Sunshine reported annual revenues of more than $300 million in 2000 and 2001, employed over one thousand people and had operations in 15 countries.

The SEC charged that Nature's Sunshine had violated the securities laws in that NSP's Brazil subsidiary (1) made payments to custom brokers in Brazil, some of which were later paid to Brazilian customs officials to allow Nature's Sunshine's unregistered products to be imported and then sold in Brazil; and (2) falsified its books and records to hide the nature of the payments.

It is by no means clear what steps the COO and the CFO of such a company are obligated to take in supervising their subordinates with respect to the books and records and internal controls of the company.

The staff did not identify any reason why either the COO or the CFO should have believed that the individuals responsible for these matters were not meeting their responsibilities.

Indeed, the SEC did not explain in what respect NSP's COO and CFO had failed adequately to supervise personnel who were responsible for the making and keeping of the relevant books and records and maintaining a system of internal controls sufficient to have provided reasonable assurance that the registration of certain products was adequately monitored.

Yet the SEC obtained not only an injunction against both the COO and the CFO, but also a civil penalty.

The SEC press release announcing the enforcement action against Greenberg further appears to reinforce the view that the SEC's newly aggressive approach may be one that executives should be wary of in the future.

In that press release, one senior SEC enforcement official indicated that the SEC would seek to hold senior executives responsible without respect to whether they acted reasonably and in good faith:

"Executives who are responsible for financial reporting and controls will be held accountable when they or their companies orchestrate fraudulent transactions to polish results and mask the truth from investors."

Andrew M. Calamari, associate director of the commission's New York regional office, quoted in SEC Press Release No. 2009-180, "SEC Charges Hank Greenberg and Howard Smith for Roles in Alleged AIG Accounting Violations," (Aug. 6, 2009), www.sec.gov/news/press/2009/2009-180.htm.

The SEC has asserted § 20(a) claims against a variety of individuals, including chief executive officers, chief operating officers, chief financial officers, chief legal officers, general partners. Thus, the SEC's new aggressive assertion of § 20(a) liability could affect a number of individuals.

Conclusion

The enforcement actions against Mr. Greenberg and against the Nature's Sunshine executives indicate a new eagerness by the SEC to seek penalties against executives who are charged neither with violating nor with aiding and abetting a violation of the Exchange Act.

The SEC obtained injunctions and civil penalties against Faggioli, Huff and Greenberg and disgorgement against Mr. Greenberg. Yet to be revealed, however, is how the SEC will decide which executives should be named solely based on control person liability and whether the SEC's reliance on Section 20(a) of the Exchange Act is appropriate in such circumstances.

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] SEC Litigation Release No. 21162, "SEC Charges Nature's Sunshine Products, Inc. With Making Illegal Foreign Payments," (July 31, 2009), available at sec.gov/litigation/litreleases/2009/lr21162.htm.

[2] While the SEC has brought a number of enforcement actions that alleged control person liability, in the vast majority of these actions, under Chairman Cox, the SEC generally also charged the alleged control person with either having personally violated the federal securities laws or with aiding and abetting violations of the federal securities laws.

But see, e.g., SEC Litig. Rel. No. 19950, "SEC Files Settled Charges Against Broker-Dealer Friedman, Billings, Ramsey & Co. Inc., in Connection with CompuDyne Pipe Offering, for Policies and Procedures Failures Relating to Handling of Material, Nonpublic Information, Insider Trading and Unregistered Sales of Securities," (Dec. 20, 2006), available at www.sec.gov/litigation/litreleases/2006/lr19950.htm (former compliance director of Friedman Billings settled as controlling person of the company for failure by Friedman Billings to maintain and enforce adequate policies and procedures to prevent the misuse of material, nonpublic information).

[3] SEC Litigation Release No. 21170, "SEC Charges Hank Greenberg and Howard Smith for Roles in Alleged AIG Accounting Violations," (Aug. 6, 2009), available at sec.gov/litigation/litreleases/2009/lr21170.htm.

[4] The SEC's newly aggressive approach also is illustrated by the SEC's recent action against an executive based solely on Section 304 of the Sarbanes Oxley Act of 2002 — a first for the SEC which it proudly stated in its news release. SEC Press Rel. No. 2009-167, "SEC Seeks Return of $4 Million in Bonuses and Stock Sale Profits From Former CEO of CSK Auto Corp., Enforcement Action Is First Solely Under 'Clawback' Provision of Sarbanes-Oxley Act" (SEC July 22, 2009) available at sec.gov/news/press/2009/2009-167.htm.

In that matter, the SEC filed an enforcement action against Maynard L. Jenkins, the former chief executive officer of CSK Auto Corporation ("CSK Auto"), asking the court to order him to reimburse CSK Auto and its shareholders for the more than $4 million that Jenkins received in bonuses and stock sale profits while CSK Auto committed accounting fraud. SEC v. Maynard L. Jenkins, (July 22, 2009).

Section 304 provides that in certain circumstances if an issuer is required to restate its financial statements as a result of misconduct, the CEO and the CFO shall reimburse the issuer for any bonus or other incentive based or equity-based compensation and stock profits received by that person during the 12 months following the issuance of the originally issued financial statements. The SEC notably did not allege that Jenkins had acted negligently or in bad faith in any respect.