

# Criminal and Civil Liability for Corporations, Officers, and Directors

CAROL A. POINDEXTER, NORTON ROSE FULBRIGHT,  
WITH PRACTICAL LAW LITIGATION

Search the [Resource ID numbers in blue](#) on Practical Law for more.

**A Practice Note providing an overview of the potential criminal and civil liability that corporations, officers, and directors may face resulting from actions taken by corporate personnel. This Note offers practical advice to mitigate the risk of criminal and civil liability for corporations, officers, and directors.**

Government regulators, shareholders, and other third parties now 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 government enforcement. As a result, corporations face enormous risks, including:

- Department of Justice (DOJ) investigations.
- Indictments.
- Large fines.
- Debarment.
- Court-appointed monitors.
- Loss of reputation in the marketplace.
- The financial cost to defend themselves, including the use of employee resources.

For officers, directors, and management, the risks similarly include:

- Indictments.
- Large fines.
- Debarment.
- Probation.
- Imprisonment.

The significant penalties, and the rise in enforcement against both corporations and senior corporate executives, make it even more

important for a corporation and its executives to assess the risks related to their business operations. This Practice Note 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 corporation'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.

## CRIMINAL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS

As an artificial or fictional entity, a corporation 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 Note 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, holding 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, 494-95 (1909)).

Therefore, if there are adequate grounds to impute criminal intent to a corporation (see *Imputing the Agent's Intent to the Corporation*), it may be held vicariously criminally liable for any act or omission an agent commits:

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

(See *United States v. Agosto-Vega*, 617 F.3d 541, 552-53 (1st Cir. 2010), *United States v. Singh*, 518 F.3d 236, 249 (4th Cir. 2008), *In re Hellenic Inc.*, 252 F.3d 391, 395-96 (5th Cir. 2001), and *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).)

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

### CONDUCT COMMITTED WITHIN THE 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 corporation and the circumstances surrounding his past conduct" (see *United States v. Bi-Co Pavers, Inc.*, 741 F.2d 730, 737 (5th Cir. 1984)).

The term "scope of employment" has been broadly 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.*, 467 F.2d 1000, 1004 (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 corporation's policies or compliance programs (see *United States v. Twentieth Century Fox Film Corp.*, 882 F.2d 656, 660 (2d Cir. 1989)). It becomes a question of fact whether the corporation 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) (Companies "[m]erely stating or publishing [] instructions and policies without diligently enforcing them is not enough to place the acts of an employee who violates them outside the scope of his employment.") and *Ionia Management 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 corporation, but this need not be the sole motivation (see *United States v. Gold*, 743 F.2d 800, 823 (11th Cir. 1984)). If the agent acted with the intent to benefit the corporation in some way, the act is imputed to the principal whether the corporation benefitted or not, or even if the result adversely affected the corporation's interests (see *Standard Oil Co. of Tex. v. United States*, 307 F.2d 120, 128-29 (5th Cir. 1962)).

### IMPUTING THE AGENT'S INTENT TO THE CORPORATION

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

- **Willful blindness.** 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, 856 (1st Cir. 1987)). Therefore, a corporation that suspects wrongdoing but purposely fails to investigate that wrongdoing may find itself criminally liable for its agents' criminal acts.
- **Collective knowledge.** 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, a corporation cannot avoid criminal liability simply because the company compartmentalized and divided its agents' duties (see *Bank of New England, N.A.*, 821 F.2d at 856 and *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005)). Collective knowledge, however, is not used to establish corporate intent or scienter (see *Southlands Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004)).

- **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 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, 1215 (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 some civil conspiracy cases, a corporation cannot conspire with its agents. Similarly, the agents, when acting in the scope of their employment, cannot conspire among themselves. Therefore, the multiplicity of actors necessary to prove the formation of a conspiracy is not present. In contrast to civil conspiracy cases, courts have recognized an exception to the Intracorporate Conspiracy Doctrine for intracorporate criminal conspiracies arising under 18 U.S.C. § 371 (see *McAndrew v. Lockheed Martin Corp.*, 206 F.3d 1031, 1036-38 (11th Cir. 2000)). Therefore, a corporation can be criminally charged, convicted, and sentenced under 18 U.S.C. § 371 for conspiring with its own agents to violate the law.

### LIABILITY FOR CORPORATE SUBSIDIARIES

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

- Agency.
- Mere instrumentality or unity of business.

This may be 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, 973-74 (10th Cir. 1970)).

#### Agency

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, under the vicarious liability theory, the subsidiary could be viewed as the parent's agent when the illegal conduct occurred (see Criminal Liability for Corporations, Officers, and Directors). If the parent's management

instructs the subsidiary to commit a crime, the parent is liable for the subsidiary's misconduct. (See *United States v. Bestfoods*, 524 U.S. 51, 64-65 (1998), and see also *Pearson v. Compenent Tech. Corp.*, 247 F.3d 471, 487 (3d Cir. 2001) and *Helm v. Alderwoods Group, Inc.*, 696 F. Supp. 2d 1057, 1069-70 (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 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, 402-03 (1960) and *United States v. Jon-T Chems., Inc.*, 768 F.2d 686, 691 (5th Cir. 1985)).

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, 966 (E.D. Wis. 1971), *aff'd* 492 F.2d 1246 (7th Cir. 1974)). 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 officers and directors.
- 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 69-70 (noting that it is not enough to show that the parent and subsidiary shared directors; rather, to establish liability, the government must overcome the general presumption to the contrary and show that when directing the acts of the subsidiary, the dual directors were, instead, acting as directors of the parent), *Key v. Liquid Energy Corp.*, 906 F. 2d 500, 503-504 (10th Cir. 1990) (holding that plaintiffs' showing was insufficient where the only things linking parent and subsidiary were a sign designating the subsidiary and the mailing address for both corporations was the same), *Miles v. Am. Tel. & Tel. Co.*, 703 F.2d 193, 195-96 (5th Cir. 1983), and *Sun Microsystems Inc. v. Hynix Semiconductor Inc.*, 622 F. Supp. 2d 890, 899-900 (N.D. Cal. 2009).)

### STRICT LIABILITY FOR CORPORATE EXECUTIVES

The US Supreme Court established the responsible corporate officer (RCO) doctrine in *United States v. Dotterweich*, holding that a corporate officer could be criminally liable for a violation of a regulatory offense, despite being unaware of the wrongdoing (320 U.S. 277, 284-85 (1943)).

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 US Supreme Court in *United States v. Park* emphasized the limiting principle articulated in *Dotterweich*, which restricts liability to corporate officers who are at least partially responsible for committing the offense (421 U.S. 658, 672-73 (1975)). In other words, a corporate officer without knowledge or involvement in a subordinate's illegal conduct may be held criminally liable 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 their duty to search for and correct them when they occurred.

(See *Park*, 421 U.S. at 673-74.)

Originally, the RCO doctrine applied to misdemeanor public welfare offenses that did not have a mens rea requirement. Courts, however, have expanded it to a greater number of regulatory offenses, including felonies. Industries subject to public health and welfare regulations are particularly susceptible to prosecution. Those industries include:

- Pharmaceutical companies.
- Compounding pharmacies.
- Medical-device companies.
- The retail-food industry.
- The agricultural sector of the food industry.

The Food and Drug Administration's Regulatory Procedures Manual sets out the following factors it evaluates when considering to recommend a misdemeanor prosecution against a corporate official under the Park Doctrine:

- The individual's position in the company and relationship to the violation.
- Whether the official had the authority to correct or prevent the violation.
- Whether the violation involves actual or potential harm to the public.
- Whether the violation is obvious.
- Whether the violation reflects a pattern of illegal behavior or failure to heed prior warnings.
- Whether the violation is widespread.
- Whether the violation is serious.

(Regulatory Procedures Manual, Special Procedures and Considerations for Park Doctrine Prosecutions, 6-5-3.)

The strongest defense is that the regulation at issue was outside the corporate executive's area of responsibility. Other affirmative defenses that have yielded varying results include:

- The corporate executive had no way to prevent the regulatory violation.
- The corporate executive took extraordinary care to prevent regulatory violations (see *United States v. New Eng. Grocers Supply Co.*, 488 F. Supp. 230, 234 (D. Mass. 1980) (defendants could present evidence that they exercised extraordinary care)).

- A subordinate employee failed to follow directions and caused the regulatory violation (see *United States v. Starr*, 535 F.2d 512, 515-16 (9th Cir. 1976) (rejected affirmative defense that the corporate executive could not prevent the violation because a subordinate employee did not follow the executive's instructions)).

Application of the RCO doctrine can have serious consequences for corporate executives. For example, in 2011, four corporate officers of Synthes, a medical device company, pled guilty and accepted responsibility for the company's crimes of running unauthorized clinical trials and engaging in off-label marketing for testing spinal repair products on patients without FDA approval. The court imposed sentences on the four executives ranging from six to nine months imprisonment and fines of \$100,000 each. This was the first time that executives had gone to prison for this charge. (*United States v. Synthes*, No. 09-cr-403 (E.D. Pa.))

Senior corporate management should be:

- Involved in regularly evaluating the effectiveness of the corporation's compliance program (see *Reducing Liability With an Effective Compliance Program*). For more information on compliance programs, see Practice Note, *Trends in Federal White Collar Prosecutions: Effective Compliance Programs May Be the Best Defense to White Collar Prosecutions* (9-503-0747) and In-House Compliance Center (2-563-8225).
- Vigilant in identifying and correcting problems.

## GOVERNMENT POLICIES AND ENFORCEMENT EFFORTS

In response to the WorldCom and Enron scandals, the federal government took several steps, including passage of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7201 et seq.). When assessing a corporation's potential liability, counsel should consider:

- The Principles of Federal Prosecution of Business Organizations in the US Attorneys' Manual (US Attorneys' Manual 9-28.000).
- The Organizational Sentencing Guidelines set out in Chapter 8 of the US Sentencing Guidelines, published by the US Sentencing Commission.

Implementation of an effective compliance program can significantly reduce liability risk. For more information on compliance programs, see Practice Note, *Trends in Federal White Collar Prosecutions: Effective Compliance Programs May Be the Best Defense to White Collar Prosecutions* (9-503-0747).

## DOJ GUIDELINES

The DOJ's charging guidelines require prosecutors to consider bringing criminal charges based, in part, on whether a corporation has behaved in a way meant to obstruct the government's investigation of corporate misconduct.

Generally, a corporation seeking leniency from the government must:

- Conduct an internal investigation that determines the scope of the conduct at issue and identifies the factors that caused it.
- Timely disclose to the government the results of its internal investigation. The investigation results will nearly always include information protected by the attorney-client privilege or under the work product doctrine, which counsel must handle carefully.

- Implement remedial measures to address any compliance shortcomings uncovered during the investigation.
- Identify any responsible individuals, along with detailed facts about the conduct.

## The Filip Memo

In 2008, then-Deputy Attorney General Mark R. Filip issued revisions to the Principles of Federal Prosecution of Business Organizations in the US Attorneys' Manual (Filip Memo). The Filip Memo revised previous guidance on whether a corporation has been cooperative in the government's investigation of corporate misconduct and, therefore, eligible to receive cooperation credit.

Before the Filip Memo, 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 Memo 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).)

When presenting information to the government that is protected by the attorney-client privilege or under the work product doctrine, counsel should consider:

- Giving the government the information, but not the protected documents.
- Providing as much information as possible verbally.
- Minimizing the risk of subject matter waiver.
- Asking to enter into a confidentiality agreement with the government.

In addition, the Filip Memo provides that when deciding whether to charge a corporation with wrongdoing, the government may no longer consider whether the corporation advanced attorneys' fees to employees or entered into a joint defense agreement. For a sample joint defense agreement, see Standard Document, *Joint Defense and Confidentiality Agreement* (2-501-9461).

## The Yates Memo

In 2015, Deputy Attorney General Sally Yates issued the Memorandum on Individual Accountability for Corporate Wrongdoing (Yates Memo). The Yates Memo revised the Principles of Federal Prosecution of Business Organizations and the Commercial Litigation provisions in the US Attorney's Manual (US Attorneys' Manual 9-28.000 and US Attorneys' Manual 4-4.000).

The Yates Memo lays out measures that the DOJ will take in any investigation of corporate misconduct, civil or criminal, to identify and prosecute the individuals responsible for the illegal corporate conduct. The Yates Memo specifically:

- Ties any eligibility for cooperation credit to the corporation providing the DOJ with all relevant facts about the individuals responsible for the misconduct.



- Requires that federal prosecutors focus on the individuals responsible for the misconduct from the beginning of the investigation and precludes them from releasing responsible individuals from civil or criminal liability when settling the matter with the organization absent special circumstances and the approval of senior DOJ officials.
- Requires prosecutors to have a clear plan for resolving cases with individuals before it resolves the case with the corporation.

The Civil Division is to apply the Yates Memo's emphasis on bringing cases against individuals regardless of an individual's ability to pay a fine.

The Yates Memo's emphasis on prosecuting individuals may make employees less likely to cooperate in a corporation's internal investigation. As a result, it may be harder for corporations to provide the DOJ with the information required to receive cooperation credit. The Yates Memo also raises the issue whether, when interviewing employees, corporate counsel must provide more robust Upjohn warnings that disclose the company's obligations to provide the DOJ with detailed information about any wrongdoers to receive cooperation credit.

While the DOJ maintains that waiving privilege is not required, some US Attorneys' Offices are requiring corporations to provide "interview downloads" to comply with the Yates Memo. Prosecutors have taken the position that counsel for the corporation can provide the interview downloads by:

- Reading the interview memorandum to the prosecutor.
- Providing a copy of the interview memorandum to the prosecutor.
- Providing the interview memorandum to the prosecutor to review in counsel's presence and then return to counsel.

The DOJ's position is that the contents of the interview memorandum recounting the information the interviewee provided to counsel are not privileged. Many defense attorneys disagree and believe that all information disclosed during a witness interview is protected by the attorney-client privilege and under the work product protection (see *Upjohn Co. v. United States*, 449 U.S. 383, 390-97 (1981)). For more information on the attorney-client privilege, see Practice Notes, Attorney-Client Privilege: Identifying the Attorney and the Client: Upjohn Test ([9-502-8339](#)) and Work Product Doctrine: Protected Information: A Lawyer's Communications with Third Parties ([6-504-4171](#)).

For more information related to the Yates Memo, see I Want You! DOJ's New Policy on Corporate Investigations Focuses on Individuals ([w-000-6027](#)) and Article, Expert Q&A on the DOJ's Yates Memo ([w-001-6060](#)).

### Corporate Joint Defense Agreements with Employees

Despite the DOJ's statements that it does not consider them, joint defense agreements between the corporation and an employee may be disadvantageous to the company in most instances. A joint defense agreement with an employee gives the employee control over the information she discloses to the corporation. As a result, the corporation may only be able to use internally the information the employee discloses and may be precluded from disclosing the information to the DOJ. To receive cooperation credit, the Filip

Memo and the Yates Memo require corporations to disclose all relevant facts about the misconduct and the individuals responsible. Therefore, a joint defense agreement with an employee could result in a company being prevented from receiving cooperation credit because it cannot disclose all relevant facts. The DOJ views joint defense agreements with employees involved in the misconduct unfavorably. Therefore, the DOJ is unlikely to provide any accommodation to a company where it is precluded from disclosing information due to a joint defense agreement with an employee. As a result, corporations should evaluate thoroughly whether to enter into a joint defense agreement with an employee.

### ORGANIZATIONAL SENTENCING GUIDELINES

The Organizational Sentencing Guidelines apply to:

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

(US Sentencing Guidelines § 8A1.1.)

The Organizational Sentencing 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 sentence (see *United States v. Booker*, 543 U.S. 220, 226 (2005)).

The Sentencing Guidelines generally measure the severity of an offense 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 the government once it discovered the offense.

The measurement of organizational guilt under the Organizational Sentencing Guidelines may impact the fines assessed for the offense (US Sentencing Guidelines §§ 8C2.4, 8C2.5, 8C2.6, 8C2.7, and 8C2.8). A corporation that can demonstrate it instituted a strong and effective compliance program capable of detecting and preventing wrongdoing (see Reducing Criminal Liability with an Effective

Compliance Program), and cooperated fully during the government's investigation of the offense, can significantly reduce its 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.

### REDUCING CRIMINAL 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 the government to exercise discretion in how it charges 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 Organizational Sentencing Guidelines, an effective compliance program may reduce the criminal fines calculated for an offense by significantly lessening the measurement of organizational guilt (see Organizational Sentencing Guidelines). However, an effective compliance program does not necessarily insulate a corporation from criminal liability (see, for example, *Twentieth Century Fox Film Corp.*, 882 F.2d at 660 and *United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1983)). For more information on the benefits of a compliance program, see Practice Note, Advantages of Implementing a Legal Compliance Program ([3-608-7199](#)).

The key to gaining any reduction in penalties depends on the corporation'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, for example, with standards and procedures, 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.

(US Sentencing Guidelines § 8B2.1.)

Recently, the DOJ's Fraud Section introduced a Foreign Corrupt Practices Act (FCPA) enforcement pilot program to encourage companies to voluntarily self-disclose FCPA-related misconduct. To receive remediation credit, the pilot program's guidance sets out a non-exhaustive list of items necessary for an effective compliance program, including:

- A chief compliance officer with the authority necessary to execute an effective program, including:
  - direct access to the board of directors; and
  - unencumbered access to all company operations.
- Experienced compliance personnel, who have sufficient independence to prevent and identify misconduct.
- Appropriate internal controls.
- A clear code of conduct and compliance policies.
- Ample resources, including a separate budget for the compliance department.
- Compensation for compliance personnel commensurate with their importance and the size of the company.
- Regular audits of the program.
- Periodic trainings.
- Administration of appropriate disciplinary measures.

For more details on the DOJ's pilot program, see Legal Update, DOJ Launches FCPA Self-Reporting Pilot Program ([w-001-8495](#)).

In addition, a 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.

However, a corporation'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 Sentencing Guidelines provide for the possibility of leniency even if a top executive or other high-level officer was involved in the wrongdoing provided the corporation meets certain other specified requirements (US Sentencing Guidelines § 8C2.5(f)).
- The corporation failed to timely self-disclose the offense.

### CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS

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 corporations and corporate executives, including:

- Securities and Exchange Commission (SEC) enforcement actions.
- Shareholder derivative lawsuits.

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. 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. For more information on the SEC's use of administrative proceedings, see Legal Update, *OIG Finds No Merit to Claims Against ALJs of Bias in SEC Proceedings* ([w-001-4999](#)).

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 (for more information on insider trading, see Practice Note, *Defending Against Insider Trading Claims* ([w-000-5992](#))).
- 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, 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 the 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 written report recounting the review's findings.

Despite recognizing the public interest in preserving privileges, the Seaboard Report indicates that a corporation seeking cooperation credit must provide the SEC with all relevant information, regardless of whether the information is protected by the attorney-client privilege or under the work product doctrine. While in prior 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 its determination to provide cooperation credit in settlements, the SEC's most recently re-published Enforcement Manual has refined that position.

### Cooperation Credit: The SEC's Enforcement Manual

The SEC Division of Enforcement Manual, re-released in 2015, helps improve the transparency of the Enforcement Division's procedures and provides further guidance on when a corporation 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 waivers of the attorney-client privilege or work product protection. The Enforcement Manual notes, however, that the staff always may request relevant non-privileged information, including factual information acquired from employee interviews that corporate counsel conducted during an internal investigation. The Enforcement Manual further states that a legitimate attorney-client privilege or work product protection claim "will not negatively affect that party's claim to credit for cooperation." Many defense attorneys, however, view all information disclosed during a witness interview to be protected by the attorney-client privilege and under the work product protection. (See *Upjohn*, 449 U.S. at 390-97.) For more information on the attorney-client privilege, see Practice Notes, *Attorney-Client Privilege: Identifying the Attorney and the Client: Upjohn Test* ([9-502-8339](#)) and *Work Product Doctrine: Protected Information: A Lawyer's Communications with Third Parties* ([6-504-4171](#)).

It is unclear whether and to what extent a party may enhance its cooperation credit by, in addition to disclosing the facts, also waiving the attorney-client privilege and work product protection and turning over attorneys' notes and memoranda. The proposed Attorney-Client Privilege Protection Act of 2009 would have resolved that uncertainty by prohibiting government attorneys from attaching any weight whatsoever 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 (Pub. L. No. 111-203, 124 Stat. 1376 (2010)). Generally defined, a control person is anyone in the organization who holds significant decision-making authority, such as:

- Board members.
- Owners of broker-dealers.
- Senior executives, including:
  - chief executive officers;
  - chief financial officers; and
  - chief compliance officers.

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 FCPA’s anti-bribery, books and records, and internal controls provisions, as well as other securities laws, based solely on its Brazilian subsidiary’s actions (see *SEC v. Nature’s Sunshine Prods., Inc.*, Litigation Release No. 21162, 2009 WL 2356796 (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.

The US Courts of Appeals are 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 instead requires only a showing that the defendant:
  - actually participated in the operations of the business; and
  - had the 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, 301-03 (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.

## 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 to initiate an action as a derivative plaintiff, theoretically on behalf of the corporation, to protect and benefit all of the corporation’s shareholders from improper management.

Shareholder derivative lawsuits usually involve claims against the corporation’s officers and directors for breach of fiduciary duty. The fiduciary duties that officers and directors owe their corporations include the duties of due care and loyalty, and require officers and directors to obey the law. Claims for breach of fiduciary duty typically arise when a company’s officers and directors cause the company to break the law, exposing it to criminal or civil penalties, massive losses, and damaging litigation, including securities fraud class actions. Under *In re Caremark International, Inc.*, these claims also can arise if directors fail to exercise the appropriate oversight over the company, including its compliance program (see 698 A.2d 959 (Del. Ch. 1996)).

For more information on securities class actions, see Practice Note, Securities Litigation: Mapping a Strategy for Defending Against Fraud Claims ([w-000-3629](#)).

## 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 either:

- The officers or directors 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 officers and directors’ counsel (see *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1315-17 (3d Cir. 1993) and *Baytree Capital Assocs. v. Quan*, 2008 WL 3891226, at \*8 (C.D. Cal. Aug. 18, 2008)).

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, 404-05 (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 did not retain independent counsel (see *In re Par Pharm., Inc. Derivative Litig.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990)).



### The Business Judgment Rule

Officers and directors may be personally liable to the company's shareholders for certain company actions. 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" (*Gantler v. Stephens*, 965 A.2d 695, 705-706 (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, 902 (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, however, the Delaware Court of Chancery has significantly developed it in modern times. The business judgment rule 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), *aff'd* 906 A.2d 27 (Del. 2006)). 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 *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 927-28 (Del. 2003), *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360-61 (Del. 1993), and *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by Gantler*, 965 A.2d at 713 n.54.)

### 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.
- Staying informed of the implementation of any changes to the compliance program instituted or approved by the board, where appropriate.
- Without waiving privileges, making sure the board's minutes reflect that the board consulted with experts and legal counsel, where appropriate.

#### ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at [legalsolutions.com/practical-law](https://legalsolutions.com/practical-law). For more information or to schedule training, call **1-800-733-2889** or e-mail [referenceattorneys@tr.com](mailto:referenceattorneys@tr.com).