

## Control Person Liability: Tips For Investment Firms

*Law360, New York (September 21, 2011, 12:19 PM ET)* -- Investment firms face an ever-expanding range of legal risks associated with making and managing their portfolio company investments. One area of liability that has seen an expansion is “control person” liability under the federal securities laws. This theory is traditionally used against officers and directors of companies alleged to have violated the securities laws, the premise being that these individuals “control” the primary violator.

But recent decisions and U.S. Securities and Exchange Commission actions have expanded the scope of control person liability to expose entities and individuals with more peripheral involvement with the primary violator. In light of this increased exposure, investment firms need to pay close attention to potential control person liability issues in connection with their investments. This article explores the implications of control person liability as it relates to investment firms and their personnel, offering practical steps to limit risks associated with such exposure.

### Standards for Control Person Liability

Section 15 of the Securities Act of 1933 (“Securities Act”) and Section 20(a) of the Securities and Exchange Act of 1934 (“Exchange Act”) provide that one who “controls” a person liable under another provision of the Securities Act or Exchange Act is liable to the same extent as the controlled person (i.e., the primary violator). Section 15 and Section 20(a) generally have been interpreted in the same manner. To plead a claim for control person liability, the plaintiff must establish (1) a primary violation of the securities laws and (2) control over the primary violator by the alleged control person.

### Pleading Standards

District courts essentially have applied two distinct standards in determining whether a plaintiff has pled control. The U.S. Supreme Court has yet to resolve this split in authority.

Under the “culpable participation” standard, which is the law in the Second, Third and Fourth Circuits, a plaintiff must plead and prove that “the control person was in some meaningful sense a culpable participant in the primary violation.”[1]

By contrast, under the “potential control” standard, which is the law (with varying permutations) in the Fifth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh Circuits, a plaintiff must show “the power to control the transaction underlying the alleged securities violation and not the exercise of that power.”[2] In other words, the “potential control” standard requires a plaintiff to allege that the defendant “had the power to direct or cause the direction of the management and policies” of the company, regardless of whether he or she exercised such control.

## **Affirmative Defense**

Even if a defendant is found to have controlled the primary violator, that defendant will not be liable if it can establish the “good faith” affirmative defense. To prove good faith, a defendant must show that “he exercised due care in his supervision of the [primary] violator’s activities in that he maintained and enforced a reasonable and proper system of supervision and internal controls.”[3] In practical terms, defendants’ first opportunity to demonstrate “good faith” will come at the summary judgment phase.

## **Implications for Investment Firms**

The potentially wide reach of control person liability creates exposure for investment firms and their personnel by virtue of ownership of portfolio companies and placing designees as directors on those portfolio companies’ boards.

Whether an investment firm or its personnel are found to have controlled a primary violator will depend on a number of factors, including (1) the firm’s percentage ownership of the primary violator; (2) whether the firm has the ability to designate members to the board of the primary violator, and the percentage of the board that is comprised of the firm’s designees; and (3) the role the firm and its personnel play in regard to the public statements made by the primary violator (such as financial reporting).

## **Ownership and Governance**

Courts generally hold that a minority ownership interest in the primary violator and minority membership on the board of the primary violator are not, by themselves, sufficient to plead control. Majority ownership interest, coupled with the ability to appoint a majority of the board of directors, may be a different story.

For example, courts have dismissed control person claims against companies that owned a 22-percent[4] and a 30-percent[5] interest in the primary violator, and claims against defendants who owned 38 to 50 percent of the stock of the primary violator and also placed designees on the primary violator’s board.[6] Conversely, where defendants were the largest stockholders of the primary violator (owning over 50 percent of the stock), had the power to elect a majority of the members of the primary violator’s board, and seated their own officers on the primary violator’s board, such facts were sufficient to allege the existence of control.[7]

While investment firms’ decisions about the ownership interest and governance typically are driven by economic and practical business considerations, firms should be aware that acquisition of significant ownership interests and governance rights in the management of a portfolio company increase the chances of exposure to control person liability. As discussed below, investment firms can mitigate exposure by ensuring that portfolio companies obtain adequate directors’ and officers’ liability insurance.

## **Public Statements — Proceed with Caution**

Two recent decisions — one from the United State Supreme Court and another from the United States Court of Appeals for the Second Circuit — highlight the role of company advisors with respect to those companies’ public statements. The Supreme Court’s June 2011 decision in *Janus Capital Group Inc. v. First Derivative Traders* appears to invite control person liability claims against persons who have a role in the creation of a company’s public statements.

In writing for the majority, Justice Clarence Thomas held that persons who draft — but do not issue — allegedly false statements cannot be liable for violations of Section 10(b), comparing it to a speechwriter crafting a speech.[8] In so doing, the Supreme Court noted that the plaintiff’s “theory of liability based on a relationship of influence resembles the liability imposed by Congress for control” of the primary violator under Section 20(a) of the Exchange Act. In other words, the speechwriter should not be considered a primary violator, but, if he has sufficient influence over the speech-giver, he may be liable under a control person theory.

In May 2011, the Second Circuit rejected a claim by holders of interests in securitized mortgage pools that the rating agencies “controlled” the banks that securitized the pools and made allegedly false statements to investors.[9] Plaintiffs’ control theory was that, rather than serving as mere passive evaluators of risk, the rating agencies aided in the structuring and securitization process, including providing “feedback” on which combinations of loans and credit enhancements would generate a particular rating.

Like the Supreme Court in *Janus*, the Second Circuit focused on the defendants’ ability to influence the content of the statements, making a distinction between the ability to provide advice on the content of statements and the power to direct the content of statements. The Second Circuit held that “allegations of advice, feedback, and guidance fail to raise a reasonable inference that the rating agencies had the power to direct, rather than merely inform, the banks’ ultimate structuring decisions. ... [P]roviding advice that the banks chose to follow does not suggest control.”

In the wake of the *Lehman Bros.* and *Janus* decisions, investment firms should carefully delineate their roles to the extent they participate in the financial reporting of the portfolio companies. For instance, if an investment firm intends to inform and guide the portfolio company’s financial reporting process, it should make clear that the portfolio company has ultimate decision-making authority concerning the content of the statements.

## **SEC Scrutiny**

The SEC traditionally has not used control person liability to prosecute enforcement actions against individuals. In 2009, however, the SEC brought an action against Nature’s Sunshine Products Inc. in which the commission alleged that the company’s CEO and chief financial officer were liable as control persons in connection with the company’s alleged violations of the Foreign Corrupt Practices Act.

According to the SEC’s allegations, Nature’s Sunshine violated the FCPA by paying bribes to employees of the company’s Brazilian subsidiary and by failing to keep accurate books and records in connection with those payments. The SEC alleged that the company’s CEO (who was the chief operating officer during the relevant time period) and CFO were liable as control persons for the company’s FCPA violations. Even though the CEO and CFO were not involved in the underlying misconduct, the SEC’s theory was that the CEO had overall responsibility for the company’s international operations, while the CFO had supervisory responsibility for the management of, and policies concerning, the company’s books and records.

The company and its officers settled with the SEC without admitting or denying liability and paid fines. The lesson of Nature’s Sunshine is that potential control persons must take a proactive approach to compliance by ensuring that there are adequate internal controls in place to prevent and detect securities law violations. While the SEC typically does not sue directors unless there are indications that directors blatantly ignored red flags or were involved in the underlying violations, Nature’s Sunshine puts individuals on notice that the SEC is willing to break the mold.

## **Practical Advice for Investment Firms and Their Personnel**

Given the potentially wide reach of control person liability, investment firms should consider the following actions to minimize their risk of exposure:

### *Ownership Interest*

Firms should consider alternatives to 100-percent ownership, including formation of a joint venture owner or making a minority investment.

### *Directors and Officers Insurance*

While investment firms typically carry directors and officers insurance to cover personnel who serve on the boards of portfolio companies, ideally, the first layer of coverage should be provided by the portfolio company's policy and the terms of that policy should cover losses arising out of control person liability claims. If a portfolio company spins off a subsidiary that creates a meaningful risk of additional exposure (such as when the subsidiary is a public company), an investment firm sponsor should ensure that there is adequate coverage for control person claims arising out of statements made by the subsidiary.

### *Governance*

When a portfolio company is not required to have the majority of its board made up of independent directors (such as in the case of master limited partnerships listed on the New York Stock Exchange), firms may consider nevertheless providing for the election of majority independent directors at the portfolio company level, rather than having a majority of directors appointed by the sponsor.

### *Documenting "Good Faith"*

Because a defendant may defeat a control person claim by demonstrating that it acted in "good faith," investment firms' board designees should be careful to document their oversight. This includes memorializing the contents of communications with management, observing corporate formalities, such as regularly holding board meetings, and ensuring that board meeting minutes are accurate.

## **Conclusion**

In evaluating costs and benefits of potential ownership structures, investment firms should be mindful of the various iterations of control person liability. Given the unsettled scope and meaning of "control," investment firms should take important practical steps to mitigate their risks, such as securing adequate D&O liability coverage and adequately training their professionals to serve as portfolio company directors.

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[1] See, e.g., *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998).

[2] See, e.g., *Maier v. Durango Metals Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998).

[3] *SEC v. First Jersey Sec. Inc.*, 101 F.3d 1450 (2d Cir. 1996).

[4] *In re Deutsche Telekom*, No. 00 CIV 9475 SHS, 2002 (S.D.N.Y. Feb. 20, 2002).

[5] *In re Flag Telecom Holdings Ltd. Sec. Litig.*, 352 F. Supp. 2d 429 (S.D.N.Y. 2005).

[6] *Zishka v. American Pad & Paper Co.*, No. CIV. A. 3:98-CV-0660-M, 2001 (N.D. Tex. Sept. 28, 2001), *aff'd*, 72 Fed. Appx. 130 (5th Cir. 2003).

[7] *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 945-56 (9th Cir. 2003).

[8] *Janus Capital Group Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

[9] *In re Lehman Bros. Mortgage-Backed Sec. Litig.*, No. 10-0712, 2011 (2d Cir. May 11, 2011).

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