Officer & Director Bars in the Current Financial Crisis

By R. Daniel O'Connor and Annmarie A. Tenn

Director Summary: The authors posit that the current economic climate might result in increased scrutiny of directors and sanctions by the SEC in securities fraud cases. In particular, directors facing fraud allegations may be, more than ever, at risk of receiving career-ending officer and director bars.

An officer and director bar is one of the most severe sanctions that an individual in an SEC fraud case can face. It causes an instant end to a public-company career, and even bars of short duration can have a life-long negative effect.

Given the current turmoil in financial markets and the perception of a lax regulatory environment, the SEC is sure to increase its pursuit of alleged corporate wrongdoers more aggressively than ever. Officers and directors of public companies have always been attractive targets for government regulators. But now, when the need to better protect the investments of millions of American families is critical, board members, as "gatekeepers," are sure to receive heightened scrutiny. In this atmosphere, directors would do well to understand one of the principal risks they may face in an SEC fraud case, and the options for defending against a career-ending sanction.

Officer and Director Bar Rules

Federal law permits the SEC to seek a variety of remedies in their fraud enforcement cases. Among the tools in its arsenal, the SEC may obtain a court order enjoining an individual from serving as an officer or director of a public company if the person demonstrates "unfitness" to serve as an officer or director. Such an order is called an "O&D bar." The test for unfitness turns on multiple factors: (1) the egregiousness of the violation; (2) whether the defendant profited from the alleged improper acts; (3) the defendant's history of securities law violations; (4) the defendant's degree of scienter (i.e., knowledge of wrong-doing); and (5) the likelihood that the defendant will commit future violations. See, for example, *SEC v. Patel,* 61 F.3d 137, 141 (2d Cir. 1995). Although this fact-specific inquiry results in a spectrum of varying degrees of unfitness, the SEC typically seeks O&D bars of only two durations—a five-year bar or a permanent bar.

The SEC has almost reflexively sought bars upon officers and directors alleged to have engaged in intentional insider trading and other forms of self-dealing. In recent years, however, the SEC's use of O&D bars has expanded. Outside directors with substantially less involvement in the company's day-to-day operations and substantially less culpability have also been the target of O&D bars. This new focus is due in part to a change in the law. In particular, Sarbanes-Oxley lowered the statutory standard for O&D bars from "substantial unfitness" to, simply, "unfitness." The other explanation is a shift in emphasis by the SEC towards imposing individual liability over general corporate liability.

SEC v. Chancellor Corp.

Allegations suggesting that an outside director was reckless by being "asleep at the switch"—as opposed to a willful wrongdoer—have been sufficient to trigger an O&D bar. In *SEC v. Chancellor Corp.,* (D. Mass, 03-cv-10762-PBS), the SEC sought and obtained an O&D bar against an outside director who was alleged to have failed to investigate red flags in the company's financial statements. According to the allegations in the complaint, the outside director was alleged to have "recklessly signed a number of financial statements that were materially misleading and took no care to ensure their accuracy." The essence of the SEC's allegations was that the director, despite red flags raised by the company's original outside auditor who was fired and immediately replaced, failed to follow up on the legitimacy of management's accounting decisions in connection with an acquisition. The director, a member of

the board's audit committee, never followed up on the questions raised by the original auditor. The director litigated the matter for a few years but eventually agreed to a settlement that included a permanent O&D bar. It is easy to imagine that the use of such a sanction may multiply as the government pursues individuals alleged to have contributed to the destabilization of the financial markets.

Acquiescence or Litigation

Historically, officers and directors faced with such sanctions have had little choice but to either acquiesce to the government's demands or engage in litigation with the SEC. Neither option is attractive, and both involve significant disadvantages. If the goal is to avoid an O&D bar, obviously agreeing to the imposition of such a bar through a voluntary settlement is a non-starter. But refusing to settle with the SEC and choosing to litigate is no sure bet either.

Short of going to trial, success will require a defendant to convince a judge that the SEC's allegations of wrongdoing have no merit—no small task given the resources that the SEC will have undoubtedly expended preparing its case. If a defendant is unsuccessful, he or she faces going to trial against an agency that has had a 90 percent success rate when taking cases to a verdict in recent years. If the SEC is successful at trial, it remains possible for a defendant to avoid an O&D bar at the remedies phase of the litigation. But such a victory seems hollow at best. Even if a defendant successfully convinces the judge to refrain from imposing an O&D bar, the defendant will be forever plagued by the trial verdict of wrongdoing, which itself can operate as a de facto O&D bar.

Bifurcated Settlements

Recently, a new approach has developed for those facing an O&D bar—bifurcated settlements. These allow defendants to enter into settlement agreements with the SEC to resolve most of the claims against them, while leaving a judge to decide whether an O&D bar should be imposed. This approach enables the government to obtain injunctions, disgorgement, and/or penalties, without expending the resources needed for a full trial. Furthermore, when the question of an O&D bar is presented to a judge for resolution, the terms of the bifurcated settlement typically prevent the defendant from denying the allegations and from contesting that a securities law violation occurred. At the same time, a bifurcated settlement leaves the ultimate questions of whether a bar should be imposed and, if so, for how long, to a neutral third-party (a judge) to answer after examining the fact-specific circumstances of the case.

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For those individuals who find themselves the target of an SEC fraud case, bifurcated settlements strike an attractive balance. They allow the government to achieve its goals and obtain the majority of the relief it seeks, while allowing officers and directors to resolve their disputes with regulators but to reserve for a judge the question of whether a bar is even appropriate.

In practice, judges asked to determine whether unfitness exists have exercised discretion and conducted very fact-specific inquiries on the issue. In several instances, judges have concluded that contrary to the SEC's request, no O&D bars were appropriate.

Conclusion

In today's current climate, the question is whether the SEC will continue its willingness to enter into bifurcated settlements that reserve the imposition of an O&D bar for a judge. Had financial markets not destabilized overnight, bifurcated settlements could easily have been framed as a win-win situation for both the SEC and those threatened with O&D bars. The SEC could have saved the expense of full trials, and secured most forms of relief that it typically seeks in its enforcement actions. At the same time, officers and directors faced with such bars could have had their alleged "unfitness" evaluated in a fact-specific inquiry by a neutral judge (which thus far has generally led to good results.)

In the current environment, it is easy to imagine that the SEC might shy away from the continued use of bifurcated settlements. The SEC's mandate to pursue wrongdoers is not only substantively important, but symbolic. The agency may want to avoid any suggestion that it is somehow soft on fraud and willing to allow those accused of wrongdoing—no matter their degree of culpability—from returning to the ranks of service as an officer or director of a public company. Only time will tell. ■

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