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Snaring 'Control Person' Executives in FCPA Liability

How sharp is the §20(a) saber the SEC has been rattling?

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APPROXIMATELY SIX MONTHS ago, there was much wailing and rending of garments among criminal defense and securities enforcement practitioners alike when, for the first time in the over 25-year history of the Foreign Corrupt Practices Act (FCPA),[1] the Securities and Exchange Commission invoked §20(a) of the Securities Exchange Act of 1934 (Exchange Act)[2] to impose FCPA liability on two corporate executives based solely on the allegation that they were "control persons" with supervisory authority over the company employees who had committed the primary FCPA violations.[3]

In "client alerts" and other missives to industry, practitioners correctly warned that the SEC appeared to be unleashing a new and less-exacting standard of FCPA liability, one that sidesteps entirely the scienter or "guilty knowledge" standards that Congress specifically wrote into the act and replaces them, instead, with notions of strict or "respondeat superior" liability for individual executives, board members and private equity investors who neither know of nor consciously avoid learning about FCPA violations occurring somewhere within the corporate chain of command.[4]

The Case That Set Off the Uproar

The case that set off this uproar was *SEC v. Nature's Sunshine Products Inc.*, No. 02-09 Civ. 0672 (D. Utah 2009).

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On July 31, 2009, the SEC announced that it had filed a settled enforcement action against Nature's Sunshine Products Inc. (NSP), Douglas Faggioli, NSP's former COO, and Craig D. Huff, NSP's former CFO.[5] Ordinarily, the announced settlement would have been viewed as an unremarkable, albeit successful, resolution in a year in which the SEC and the Department of Justice (DOJ) promised, and delivered, more FCPA enforcement activity than ever.[6] Within the charging language of the *Nature's Sunshine* complaint, however, FCPA practitioners immediately spotted a harbinger of even more aggressive FCPA enforcement to come.

According to the complaint, NSP, a Utah-based manufacturer and direct-marketer of vitamins, food supplements and personal care products, established a wholly owned subsidiary in Brazil, which swiftly became NSP's largest foreign market.[7] The complaint alleged that, in order to circumvent registration requirements that affected many of the products that NSP Brazil imported and sold, the company made over $1 million in undocumented cash payments to customs brokers, who in turn paid some of the money to Brazilian customs officials.

Instead of accurately recording those payments in its books and records, NSP Brazil booked the payments as purportedly legitimate "importation expenses."

The complaint charged that, by such conduct, NSP Brazil's parent company, NSP, had violated both the FCPA's anti-bribery provisions[8] and its accounting provisions,[9] and that NSP's executives Faggioli and Huff, as "controlling persons" within the meaning of §20(a), were similarly responsible for the accounting violations committed by their subordinates, whom they allegedly had failed "to adequately supervise."[10]

At the same time, the complaint was devoid of any allegation that Faggioli and Huff either participated in, knew of, or even consciously avoided learning about the improper payments, the inaccurate entries in NSP's books and records, or the company's lack of sufficient internal accounting controls.

Without admitting or denying those allegations, the defendants agreed to the entry of judgments enjoining them from future FCPA violations and ordering NSP to pay a civil penalty of $600,000 and Faggioli and Huff each to pay a civil penalty of $25,000.[11]

Interpreting the Potential Impact

Nature's Sunshine appears to mark the first time that the SEC has sought to hold corporate executives responsible for FCPA violations based solely on their status as "controlling persons" having supervisory authority over those who committed the primary FCPA violations.[12]

At a minimum, the Commission's choice to marry §20(a) and the FCPA in such unprecedented fashion clearly signals a more aggressive enforcement posture against corporate executives and other individuals. In turn, the mere specter of potential "control person" FCPA liability for otherwise blameless corporate executives necessarily adds to companies' already daunting task of monitoring and remediating potential FCPA liability risks. And, given that the overwhelming majority of FCPA investigations are settled short of litigation, the SEC's apparent willingness to threaten such "control person" liability likely will drive the costs of FCPA settlements even higher.[13]

At the same time, there is the risk of overestimating the potential impact of the SEC's decision in *Nature's Sunshine* to invoke §20(a) in a settled FCPA enforcement action.

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First of all, practitioners should note that the majority of circuits have not yet sanctioned the SEC's authority to invoke §20(a) in any enforcement action, let alone one under the FCPA; and at least two circuits have squarely rejected the notion. See *SEC v. J.W. Barclay & Co.*, 442 F.3d 834 (3d Cir. 2006); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974);[14] see also Kenneth Winer & Kimberly Shur, "A Mighty Sword: Should the SEC Bring Enforcement Actions Solely on the Basis of Control Person Liability?" 41 Sec. Reg. & L. Rep. 1686 (Sep. 14, 2009), available at http://www.foley.com/publications/pub_detail.aspx?pubid=6411 (arguing that "[t]he statutory language, and legislative history, of the relevant provisions of the Exchange Act and public policy do not support the application of [Section] 20(a) to SEC enforcement actions.").[15]

Second, in advising individual clients about the potential threat of "control person" FCPA liability, practitioners should be careful to distinguish between the act's criminal sanctions, on the one hand, and civil penalties, on the other.

Unlike the *Park* doctrine, for example, which provides for the imposition of strict criminal liability on corporate executives for violations of the Food, Drug and Cosmetic Act committed by their subordinates,[16] §20(a) creates, at most, a civil liability standard. Accordingly, even in those jurisdictions where courts have endorsed (or might yet endorse) the SEC's use of §20(a) as an enforcement tool, the risk of such "control person" liability does not include the prospect of a Department of Justice (DOJ) prosecution or potential conviction under the FCPA.

Third, even as to potential civil liability, practitioners should distinguish carefully between the FCPA's anti-bribery provisions and its accounting provisions. Particularly interesting in this regard is the fact that, in *Nature's Sunshine*, the SEC charged the company, NSP, with violating both the anti-bribery and the accounting provisions, but attributed "control person" liability to Faggioli and Huff only for the alleged "books and records" and "internal controls" violations.

The SEC employed such restraint notwithstanding the complaint's allegation that Faggioli had "supervisory responsibilities for the senior management and policies regarding the *worldwide* manufacture, inventory and *distribution of NSP's products*."[17] If the SEC believed that to be true, why did it not charge Faggioli under §20(a) with the anti-bribery violations as well?

While an answer cannot conclusively be gleaned from a settled complaint, the end result of untold horse trading between the parties, one possible answer is that, in drafting the FCPA's anti-bribery provisions, Congress expressly provided that civil liability would not attach to an individual unless that person acted corruptly (15 U.S.C. §78dd-3(a)) and, if liability is premised on a payment to a third party other than a foreign official, political party or candidate, while knowing that the money would be directed to a foreign official, political party or candidate (15 U.S.C. §78dd-3(a)(3)).[18]

Given that Congress wrote these standards into the FCPA-related provisions of the Exchange Act more than 40 years after §20(a) of the same statute was enacted, a colorable argument can be made that the SEC cannot legitimately invoke §20(a) as an "end around" the FCPA's more specific and exacting mens rea requirements. Well-settled principles of statutory construction teach that, when a previously enacted, broad statute conflicts with a later, specialized statute targeting a particular subject matter, the standards set forth in the later-enacted statute prevail. See, e.g., *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000).

> While it is **not** yet **clear** whether 'Nature's Sunshine' will, in the long run, represent a **seismic shift** or a **small tweak** in the enforcement landscape, it **cannot be doubted** that failure to keep a watchful eye on activities of one's subordinates can result in **heavy personal cost**.

Fourth, even as to the violations that the SEC did charge against Faggioli and Huff under §20(a), a distinction should be drawn between the individual defendants' alleged "books and records" violation and their alleged "internal controls" violation in assessing whether the agency's invocation of §20(a) was truly a watershed event.

With regard to the former violation, *Nature's Sunshine* arguably adds nothing new, given that Rule 13b2-1,[19] promulgated by the SEC in 1979, purports to create civil liability for any person who unreasonably "cause[s]" a "books and records" violation. See, e.g., *SEC v. Softpoint Inc.*, 958 F. Supp. 846, 866 (S.D.N.Y. 1997) (Rule 13b2-1 has "no scienter requirement; liability is predicated on 'standards of reasonableness'" (internal citation omitted)).

Like §20(a), Rule 13b2-1's "reasonableness" or simple negligence standard would seem to contemplate liability for an executive who fails to supervise adequately those employees responsible for the accuracy of the company's books and records.[20]

As to Faggioli's and Huff's alleged "internal controls" violations, the extent to which the *Nature's Sunshine* complaint breaks new ground is similarly unclear. Although the FCPA, on its face, seems to require proof of "a knowing[] fail[ure] to implement a system of internal accounting controls," the SEC has demonstrated a willingness, well before its invocation of §20(a) in *Nature's Sunshine*, to charge primary violations of the FCPA's "internal controls" provision based merely on allegations of "extreme recklessness" or even simple negligence.[21]

Moreover, in at least some jurisdictions, such as the Second Circuit, any plaintiff (including the SEC) invoking §20(a) must affirmatively allege some measure of "culpable participation" by the defendant in the primary Exchange Act violation. *SEC v. First Jersey Sec. Inc.*, 101 F.3d 1450, 1472-74 (2d Cir. 1996) (plaintiff asserting §20(a) claim must affirmatively allege defendant's "culpable participation" in primary Exchange Act violation); *Lapin v. Goldman Sachs Group Inc.*, 506 F. Supp. 2d 221, 246 (S.D.N.Y. 2009) ("[T]o withstand a motion to dismiss, a [S]ection 20(a) claim must allege, at a minimum, particularized facts of the controlling person's conscious misbehavior or recklessness").

Accordingly, depending on the court (and oftentimes, the judge) where one is litigating the issue, there may not be much daylight between the proof required to establish a primary "internal controls" violation and that required to prove derivative "control person" liability for such a violation.[22]

Finally, one cannot lose sight of the fact that *Nature's Sunshine* involved a settled complaint, which avoided litigation over many of the difficult statutory construction issues identified above. Clients should be reminded to beware the fallacy: If the SEC charged it, and the defendants failed to deny it, then the SEC's theory of liability must have been correct.

Let's wait and see what happens when, if ever, the agency decides to invoke §20(a) in a contested FCPA action and to subject to judicial review the new enforcement weapon it boldly wielded in *Nature's Sunshine*.

Future Trends

Whether *Nature's Sunshine* portends a new era of FCPA enforcement rife with actions against executives and other individuals who neither participated in, knew of, or even avoided learning about primary FCPA violations within their chain of command is unknown.

SEC officials, such as Cheryl Scarboro, who was appointed in January 2010 to head the agency's new FCPA Unit, repeatedly have passed up the opportunity in public fora to proclaim *Nature's Sunshine* the wave of the future. Such reticence may be due to a belief that the case is a noteworthy yet isolated result limited, for all practical purposes, by its own peculiar facts.[23]

That the government is firmly committed to expanding its FCPA-related enforcement activities is far more certain. Both SEC Director of Enforcement Robert Khuzami and Lanny A. Breuer, the assistant attorney general for the criminal division of the DOJ, have promised to pursue aggressively civil and criminal FCPA violations. Indeed, Breuer recently took aim at executives themselves, declaring that as part of a focus on asset forfeiture, the DOJ is, when appropriate, "absolutely going to seize their profits and their land and their fancy cars and boats. We're committed to doing it."[24]

And those promises have translated into action, as 2009 saw more FCPA prosecutions and settlements than ever before. As 2010 opens, the government is showing no signs of letting up.[25]

Accordingly, no matter how one interprets *Nature's Sunshine*, corporate executives of U.S. companies must be especially diligent. They must be sure that the companies they manage continue to develop and implement rigorous programs designed to ensure FCPA compliance; regularly audit compliance and ethics programs to ensure that they remain "state-of-the-art" in a fast-moving regulatory world; audit and train overseas agents, representatives and other third parties; and swiftly investigate red flags and remediate any issues or concerns.

If nothing else, those steps surely can help executives preserve their "good faith" defenses to any alleged §20(a) liability.

But prudent executives will do even more. They will evaluate not only their direct reports but also the larger class of employees they supervise, especially if those employees are responsible for maintaining the company's books and records and internal accounting controls. They will think carefully before cutting compliance budgets. They will react to even seemingly innocuous red flags with decisive and appropriate action. They will ensure that company disclosures are adequate and timely, and will consider self-reporting when appropriate.

While it is not yet clear whether *Nature's Sunshine* will, in the long run, represent a seismic shift or a small tweak in the enforcement landscape, it cannot be doubted that, as Faggioli and Huff learned, failure to keep a watchful eye on the activities of one's subordinates can result in a heavy, and personal, cost.

1. 15 U.S.C. §§78dd-1, et seq.
2. 15 U.S.C. §78t.
3. Section 20(a) states: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter 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."
4. See, e.g., Paul R. Berger, Sean Hecker, Steven S. Michaels and Colby A. Smith, "Control Person Liability and the FCPA: What Are the Limits and How Should Companies Respond," Debevoise & Plimpton LLP FCPA Update (Sept. 2009), available at http://debevoise.com.
5. Faggioli, who was NSP's COO and a member of its board of directors during the relevant time period, currently serves as the company's CEO. Huff, who was NSP's CFO during the relevant time period, resigned from the company in March 2006.
6. Indeed, the scope of the *Nature's Sunshine* settlement pales in comparison with countless other recent FCPA settlements, including Siemens AG's December 2008 agreement to pay a total of $800 million in criminal fines and disgorgement to settle a DOJ investigation and parallel SEC suit, and Halliburton Co.'s February 2009 agreement to pay $559 million to settle SEC and DOJ charges.
7. Complaint available at http://sec.gov/litigation/complaints/2009/comp21162.pdf.
8. 15 U.S.C. §§78dd-1 to -3.
9. 15 U.S.C. §78m(b)(2). The requirements of the FCPA's accounting provisions are twofold: Issuers must make and keep books and records that accurately and in reasonable detail reflect the company's transactions. 15 U.S.C. §78m(b)(2)(A). In addition, issuers must maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are properly authorized and recorded. 15 U.S.C. §78m(b)(2)(B).
10. See Complaint at ¶¶45, 48.
11. See SEC Litigation Release No. 21162 (July 31, 2009), http://sec.gov/litigation/litreleases/2009/lr21162.htm.
12. In *SEC v. Murphy*, No. H-02 Civ. 2908 (S.D. Tex. 2002), the SEC invoked §20(a) in charging a company president with anti-bribery and internal controls violations that, the complaint alleged, the president either knew of or, at least, avoided learning about. Complaint available at http://sec.gov/litigation/complaints/comp17651.htm.
13. Invocation of §20(a) by the SEC in FCPA enforcement actions also promises to encourage a more expansive use of such "control person" theories against board members, management and private equity investors in related derivative actions and other private plaintiff litigation. For example, in the shareholder derivative action brought against NSP and others, the plaintiffs alleged that, in addition to Faggioli and Huff, the chairman of the board of director's Audit Committee likewise was liable as a "control person" under §20(a). *In re Nature's Sunshine Prods. Inc. Sec. Litig.*, Case No. 06 Civ. 267 (D. Utah 2006).
14. In 2006, the Sixth Circuit issued an unpublished opinion in *SEC v. Smith*, 208 Fed. Appx. 402, 2006 WL 3690414 (6th Cir. Dec. 14, 2006), which appears to conflict with *Coffey*. According to Sixth Circuit rules, however, a published opinion such as *Coffey* can be overruled only through en banc consideration. See 6th Cir. R. 206(c).
15. The *Nature's Sunshine* settlement was filed in the Tenth Circuit, which has not yet examined the question of whether the SEC may properly invoke §20(a) in an enforcement action.
16. See *United States v. Park*, 421 U.S. 658 (1975).
17. Complaint at ¶43 (emphasis added).
18. As used in the FCPA's anti-bribery provisions, "knowing" includes not only actual knowledge, but also conscious avoidance or "deliberate ignorance" of knowable facts regarding the corrupt activities. See H.R. Rep. No. 100-576, at 919-21 (1988).
19. 17 C.F.R. §240.13b2-1 (1979) ("No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.").
20. See David P. Burns and Erin K. Sullivan, "Navigating the FCPA's Complex Scienter Requirements," Bloomberg Finance, L.P., at n.35 and accompanying text (April 2009), available at http://www.gibsondunn.com/publications/Documents/Burns-Sullivan-NavigatingTheFCPAComplexScienterReq.pdf. As Burns and Sullivan point out, Rule 13b2-1 appears to conflict with the more exacting "knowingly" standard for "books and records" and "internal controls" violations added to the FCPA by Congress in 1988. Id. Again, in this instance, a colorable argument can be made that, according to settled principles of statutory construction, the FCPA's specific and more-exacting scienter requirements should prevail over §20(a)'s lesser standard. See supra.
21. See id. at n.40 and accompanying text (citing *SEC v. Pillor*, No. 06 Civ. 4906 (N.D. Cal. Aug. 15, 2006) (in settled complaint, SEC charged senior VP with violations of the "books and records" and "internal controls" provisions of the FCPA based on allegations approximating simple negligence)).
22. *Nature's Sunshine* was brought in the Tenth Circuit, which, unlike other circuits, does not require the plaintiff to make a prima facie showing that the defendant was a culpable participant in the underlying violation committed by the controlled person. See, e.g., *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 895-98 (10th Cir. 1992), overruled on other grounds by *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). Nonetheless, according to the Sept. 24, 2009, statement of SEC Assistant Director Kara N. Brockmeyer, the SEC does not intend to invoke §20(a) in FCPA enforcement actions absent "red flags" to which the alleged control person "should have been paying more attention." See Nick Hanna & Scot Kennedy, "Corporate Officers Beware: SEC Fines U.S. 'Control Persons' for FCPA Violations of Foreign Subsidiary," All Business, Nov. 23, 2009, http://www.allbusiness.com/legal/international-trade-law-tariffs-customs-excise/13655396-1.html.
23. For whatever reason, the SEC did not include in its complaint certain allegations that appear elsewhere, including an allegation in the company's SEC filings that Faggioli knew of the bribes paid in Brazil and specifically approved at least one of those improper payments. See *In re Nature's Sunshine Prods. Inc. Sec. Litig.*, Case No. 06 Civ. 267 (D. Utah 2006).
24. Nov. 17, 2009, address to American Conference Institute's 22nd National Forum on the Foreign Corrupt Practices Act, Washington, D.C., available at http://www.justice.gov/criminal/pr/speeches/2009/11/11-17-09aagbreuer-remarks-fcpa.pdf.
25. On Jan. 19, 2010, DOJ Assistant Attorney General Breuer announced the arrests of 22 individual corporate executives and employees in an undercover FCPA sting operation targeting the military and law enforcement equipment industry. See, e.g., Evan Perez & Brent Kendall, "Twenty-Two Arrested in U.S. Bribery Probe," Wall St. J., Jan. 20, 2010, at A3.

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