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OFFICER LIABILITY

Is It Time for Corporate Executives to Be Held Accountable When Their Companies Defraud the Government?

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"It is childish, it is futile, it is ridiculous! Society cannot afford to have individuals wield the power of thousands without personal responsibility. It cannot afford to let its strongest men be the only men who are inaccessible to the law."[1]

Each year the U.S. Department of Justice publicly announces the amount of money it has recovered for the government in the preceding year from its prosecution of actions brought under the False Claims Act. Recently, the amounts have been staggering, and the trend shows no sign of abating. In fiscal year 2014 alone, the DOJ recovered almost $5.7 billion from FCA cases.[2] These actions, most of which are initiated by whistleblowers, are not only a vitally important means of returning to the government funds unlawfully obtained by the submission of false claims for payment, but also serve to deter future illegal activity.

Review of these cases reveals that individual executives, and top corporate management in particular, have only rarely been named as FCA defendants.[3] This is particularly so with respect to the largest settlements, which typically involve allegations of nationwide schemes resulting in hundreds of millions of dollars in false claims.

There are no doubt a number of reasons for the paucity of FCA cases naming top management individually; indeed, consideration of the basic elements of an FCA claim suggests two. In its simplest form, the elements of a false claim are: 1) the submission of a false claim, 2) causation and 3) scienter. Of these, the latter two pose the greater challenge when pursuing liability against those controlling the day-to-day operations of the corporation. Establishing the causal link between the actions of a chief executive officer, for instance, and the submission of false claims by others in the company may prove daunting when confronted with a corporate structure consisting of many divisions and multiple levels of management. The instances in which one can adequately plead scienter on the part of a specific corpo-

[1] Woodrow Wilson, addressing the American Bar Association National Convention on Aug. 31, 1910, regarding the individual responsibility of corporate leaders for corporate acts.

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[2] Press Release, *Justice Department Recovers Nearly $6 Billion from False Claims Act Cases in Fiscal Year 2014*, U.S. DEP'T OF JUSTICE (Nov. 20, 2014), *available at* http://www.justice.gov/opa/pr/justice-department-recovers-nearly-6-billion-false-claims-act-cases-fiscal-year-2014.

[3] This article addresses civil actions under the FCA alleging large-scale corporate fraud. The DOJ regularly brings criminal actions against individuals who commit FCA violations, and the government is increasingly using its powers of suspension and debarment against individuals. *See, e.g.*, FY12 and 13 Report by the Interagency Suspension and Debarment Committee on Federal Agency Suspension and Debarment Activities, *available at* https://isdc.sites.usa.gov/files/2014/03/ISDC-Report-FY-12-and-13.pdf.

rate executive, particularly where the whistleblower is not part of the company's management, may be limited even in cases of large scale fraud.

Confining allegations of FCA liability to the corporate entity itself rather than including the stewards of that corporation has at least two major implications. First, it misses an opportunity to hold top executives accountable when they fail to establish effective internal controls to prevent the company from submitting false claims to the government. A CEO's job includes not only avoiding personal participation in misconduct, but also preventing others within the company and under his or her authority from engaging in such activity.

Second, when corporate executives are not held accountable for failing to prevent corporate fraud, if in a good faith exercise of their managerial responsibilities they could have done so, it perpetuates the perverse incentives that arise when those executives receive incentive compensation based on the profits of the company's illegal activities, but the penalties for the illegal conduct are subsequently paid by the company itself (and its shareholders). This reality is most dramatically demonstrated when, as has often been the case, even massive FCA settlements do not result in a change in company leadership or even a measurable decrease in executive compensation.

The challenge of holding the appropriate entities or individuals responsible for corporate malfeasance is not a new one and has been addressed in a range of other contexts. The federal securities laws stand out as an instructive example of a legal liability framework that has adapted over the years to incorporate additional measures focused on top corporate executives. From their inception, the two primary federal securities laws—the Securities Act of 1933 and the Securities Exchange Act of 1934—have contained provisions that extend liability to persons who ''control'' those who commit violations of the acts. In the wake of the Enron collapse and other corporate accounting scandals of the early 2000s, Congress passed the Sarbanes-Oxley Act, which embodied the philosophy that executive accountability is a critical aspect of deterring corporate misbehavior. The certification and executive compensation clawback provisions of Sarbanes-Oxley place responsibility for corporate action on top executives and work toward ensuring that they do not personally profit from fraud at the expense of their companies and shareholders.

Control Person Liability Under the Federal Securities Laws

Section 15 of the '33 Act and Section 20(a) of the '34 Act provide, in slightly different language, that ''controlling persons'' are jointly and severally liable with ''controlled persons'' who violate other provisions of the Acts. Both statutes contain affirmative defenses, again worded slightly differently, that exclude from liability controlling persons who, generally speaking, were not aware of the violations or who undertook good faith efforts to institute compliance measures.[4]

Congress's goal in enacting these provisions was to prevent those in charge of companies from escaping prosecution by having ''dummy'' directors or executives engage in fraud from which they would profit.[5] Consistent with this legislative purpose, the Securities and Exchange Commission has promulgated a rule that defines ''control'' for these purposes as ''the possession, direct or indirect, of the power to direct or cause the direction of the management or policies of a person.''[6]

The effect of the control person provisions of the securities laws is to impose personal liability on corporate executives based on their inherent ability and responsibility to exercise managerial control over those in their company that might otherwise commit illegal acts. Importantly, these provisions accomplish this result by the use of a presumption of liability for those in control of corporate activity and place the burden on the defendant executive to show that he or she acted in good faith or otherwise took reasonable steps to avoid the violation.

The Federal Circuits differ on the specifics of what level of control or participation a plaintiff must plead to state a control person claim and what a defendant must show to prove the affirmative defense, but in all events, the control person provisions expand the scope of liability under the federal securities laws to top executives, even in situations where the executive did not personally engage in the conduct constituting the violation.[7]

In 1982, Congress reaffirmed its support for ''control person'' liability by extending it to misconduct in the U.S. futures and options markets through amendments to the Commodities Exchange Act that added provisions similar to those in the securities laws.[8]

[4] An affirmative defense is available under § 15 when ''the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlling person is alleged to exist.'' An affirmative defense under § 20(a) lies where ''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.'' Congress did not provide an explanation for any intended difference in the two defenses, which were codified at the same time.

[5] *See* Loss & Seligman, Fundamentals of Securities Regulation 1307 (5th ed. 2004).

[6] 17 C.F.R. § 230.405.

[7] In some circuits, the plaintiff must show that the controlling person was a ''culpable participant'' in the violation. *See, e.g.*, Boguslavsky v. Kaplan, 159 F.3d 715, 716 (2d Cir. 1998) (''In order to establish a prima facie case of liability under § 20(a), a plaintiff must show: (1) a primary violation by a controlled person; (2) control of the primary violator by the defendant; and (3) ″that the controlling person was in some meaningful sense a culpable participant″ in the primary violation.''). Under the prevailing view, the plaintiff need only show that the defendant had the power to control the primary violator, whether that power was actually exercised with regard to the violation, and the burden is placed on the defendant to establish an affirmative defense of good faith. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (''[T]he statute premises liability solely on the control relationship, subject to the good faith defense. According to the statutory language, once the plaintiff establishes that the defendant is a 'controlling person,' then the defendant bears the burden of proof to show his good faith.''); Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992) (''We have long viewed the statute as remedial, to be construed liberally, and ″requiring only some indirect means of discipline or influence short of actual direction to hold a 'control person' liable.'').

[8] 7 U.S.C. § 13c(b) is similar, but not exactly the same as the securities provisions: the CEA control person provision places the burden on the CFTC to prove ''that the controlling person

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Sarbanes-Oxley's Certification Requirements and Executive Compensation "Clawbacks"

After the widespread corporate scandals of the early 2000s, Congress revisited the effectiveness of the federal securities laws in addressing the then-current landscape of corporate behavior and responded by instituting some of the most far-reaching reforms since the passage of the '33 and '34 Acts. Sarbanes-Oxley added two important provisions that demonstrate Congress's belief that holding top corporate executives individually liable for corporate misbehavior, even absent a showing that those executives personally engaged in that misbehavior, is a critical tool for improving corporate compliance and deterring fraud.

Section 302 of the Sarbanes-Oxley Act requires public company CEOs and chief financial officers to make a number of personal certifications, including that the company's financial statements fairly present, in all material respects, the operations and financial condition of the company.[9] The SEC issued final rules in 2003 that further required CEOs and CFOs to certify that they are responsible for designing and maintaining internal controls over their company's financial reporting.[10] These were new certifications that went above and beyond the prior requirement that CEOs and CFOs sign their annual reports in the name of their company.[11]

Section 304 of the Sarbanes-Oxley Act requires CEOs and CFOs to pay back to their company any incentive compensation or profits from the sale of company securities that he or she obtained during any 12-month period after the filing of financial statements that were later restated due to noncompliance with the securities laws.[12] This is commonly known as a ''clawback'' provision. Liability under the provision does not require that the CEO or CFO personally engage in any misconduct, nor does it require any correlation between the harm caused by the restatement and the executive's incentive compensation or trading profits to be recouped. As one court explained, the clawback provision is intended to create the proper incentive for CEOs and CFOs to exercise due diligence in overseeing their company—''The absence of any requirement of personal misconduct is in furtherance of that purpose: it ensures corporate officers cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings.''[13] Notably, the U.S. Court of Appeals for the Second Circuit has held that the law prohibits companies from indemnifying executives for payments required under this provision.[14]

The Sarbanes-Oxley clawback performs a unique role in the scheme of individual liability for corporate executives, because on its face it regulates a matter wholly internal to the corporation—the allocation of money between the company treasury (and its shareholders) and its top executive officers. The clawback provision does not, for example, require the CEO to make any payment to the government or to anyone else (other than the company) that was harmed by the false financial statements.[15] In that respect, it serves a related but distinct function from control person liability. While the control person provisions, by way of their affirmative defenses, require a finding of fact to determine whether the control person acted in a manner that creates liability, the clawback provision strictly imputes responsibility for corporate behavior to its top executives. Simply put, the clawback provision embodies a policy that whether a CEO masterminded, or even knew of, the company's securities law violations, they should

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did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.''

[9] *E.g.*, 18 U.S.C. § 1350. The CEO and CFO also must both certify, for each of the company's quarterly and annual reports, that they have reviewed the report and based on their knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact that might make the statement misleading. Sarbanes-Oxley Act § 302; Exchange Act Rules 13a-14 and 15d-14. Sarbanes-Oxley provides for criminal penalties for violating these provisions. 18 U.S.C. § 1350.

[10] Securities Act Release No. 33-8238, Securities Exchange Act Release No. 34-47986 (June 2003).

[11] Since 1980 the SEC has required CEO and CFO signatures on public company annual reports, ''based on the expectation that corporate officers and directors would pay more attention to the disclosures made and would participate more fully in the preparation of the reports if they had to sign them.'' *Report on Review of Disclosure Requirements in Regulation S-K*, U.S. Sec. & Exch. Comm'n, at 21 n.57 (December 2013). However, the executive signatures required by these rules were on behalf of the corporation rather than on behalf of the executives in their individual capacities. *See* General Instruction D to Form 10-K.

[12] 15 U.S.C. § 7243. Technically, § 304 applies to CEOs and CFOs of any issuer and requires the reimbursement of any bonus or incentive-based or equity-based compensation during the applicable periods.

[13] SEC v. Baker, No. A-12-CA-285-SS, 2012 BL 300098 (W.D. Tex. Nov. 13, 2012) (''Apologists for the extraordinarily high compensation given to corporate officers have long-justified such pay by asserting CEOs take 'great risks,' and so deserve great rewards. For years, this has been a vacuous saw, because corporate law, and private measures such as widespread indemnification of officers by their employers, and the provision of Directors & Officers insurance, have ensured any 'risks' taken by these fearless captains of industry almost never impact their personal finances. In enacting Section 304 of Sarbanes-Oxley, Congress determined to put a modest measure of real risk back into the equation. This was a policy decision, and while its fairness or wisdom can be debated, its legal effect cannot. Section 304 creates a powerful incentive for CEOs and CFOs to take their corporate responsibilities very seriously indeed.'').

[14] 622 F.3d 188 (2d Cir. Sept. 30, 2010). In *Cohen*, the court overturned the approval of a derivative and class action settlement agreement that indemnified the company's CEO and CFO from liability under § 304. The DOJ and SEC intervened to object to the settlement, and the Second Circuit held that the settlement agreement would ''fly[] in the face of Congress's efforts to make high ranking corporate officers of public companies directly responsible for their actions that have caused material noncompliance with financial reporting requirements.''

[15] In some cases, however, the SEC can use its clawback power to force a corporate executive to repay to the company an amount that will cover the corporate penalty. In such cases, the SEC effectively obtains the corporate penalty directly from the executive. *See e.g.*, In the Matter of Babak (''Bobby'') Yazdani, Securities Exchange Act of 1934 Release No. 73201 (Sept. 24, 2014); Press Release, ''SEC Charges Software Company in Silicon Valley and Two Former Executives Behind Fraudulent Accounting Scheme,'' Securities and Exchange Commission (Sept. 24, 2014) (SEC imposed $1.75 million penalty on a company and forced the reimbursement to the company of $2.5 million in compensation to its CEO).

not be permitted to profit from them at the expense of the company and its shareholders.[16]

A Role for Individual Liability Under The False Claims Act

The policies motivating the individual liability provisions of the federal securities laws are similarly applicable to the goals that drive the government's use of the False Claims Act.

A primary purpose of both the original control person liability provisions in the '33 and '34 Acts and the more recent Sarbanes-Oxley amendments is to hold executives accountable for the actions of their companies.[17] Attorney General Eric Holder acknowledged this policy goal when he said that ''the buck needs to stop somewhere where corporate misconduct is concerned,'' during a speech wherein he called for increased whistleblower awards to help the government identify individual wrongdoers.[18] SEC Chairman Mary Jo White has similarly announced a willingness to use her agency's statutory powers creatively to target enforcement actions on the individuals ultimately responsible for corporate misbehavior, even if those individuals do not directly commit the violations.[19]

In addition, the long list of nine-figure FCA settlements with large corporations (some of which are ''repeat offenders'') in recent years suggests that the current FCA provisions are not doing all that is possible to deter these companies from engaging in large scale frauds. But it is precisely this type of massive corporate fraud of which top executives can be expected (and presumed) to have awareness and thus be in a position to prevent.

In fiscal year 2013, for instance, the lion's share of the government's $3.8 billion in FCA recoveries came from the prosecution of alleged FCA violations of this nature. For example, Abbott Laboratories settled with the government for $1.5 billion, Amgen settled for $762 million and United Technologies settled for more than $660 million, in each instance without a single corporate executive held liable.[20] The sentiment that corporate wrongdoers may no longer be dissuaded from engaging in wrongdoing by the spectra of potential FCA liability was voiced to Congress in 2011 by Lewis Morris, former general counsel to the inspector general of the Department of Health and Human Services. Morris expressed concern that healthcare providers that defraud the government had come to consider civil penalties (and even criminal fines) a mere ''cost of doing business.'' If individual members of management were faced with the possibility that they could be held personally liable as an FCA defendant if they sit back and do nothing in the face of fraud, or that their compensation package could shrink substantially due to an FCA settlement, executives would undoubtedly do more to prevent their companies from illegally obtaining government funds.

Finally, after companies settle FCA actions with the DOJ for huge sums of money, it is less than clear that they (through their board of directors, for instance) ever terminate or impose any significant penalty upon their top executives, on whose watch the fraud occurred. In fact, oftentimes top executives will see their compensation stay the same or even increase in years when their companies pay hundreds of millions or billions of dollars (of shareholders' money) to the government. In September 2009, Pfizer settled a variety of claims for the illegal promotion of its drugs and paid the government $2.3 billion.[21] Pfizer paid its CEO $14.9 million in total compensation that year, only slightly below the amount he received in 2008.[22] Similarly, when Johnson & Johnson paid more than $2 billion in 2013 to resolve FCA and other claims regarding illegal marketing and kickbacks,[23] it paid its CEO $16 million that year—a six million dollar raise from the year before.[24]

[16] That clawback provisions benefit shareholders is also evidenced by the number of shareholders that have submitted proposals to enact corporate clawback and related policies that go beyond those in Sarbanes-Oxley. For example, the New York City pension funds submitted shareholder proposals to a number of financial services and pharmaceutical companies that would permit the companies to clawback executive compensation for conduct that causes serious harm to the company, including the failure to supervise others. The New York City pension funds also submitted a proposal to one company specifically to prohibit the board from its practice of excluding compliance costs in calculating the performance metrics used to determine executive compensation. *See* 2013 Shareowner Initiatives of the New York City Pension Funds, *available at* http://comptroller.nyc.gov/reports/shareowner-initiatives/.

[17] *See e.g.*, S. Rep. No. 107-205, at *25 (2002) (''The Committee believes that management should be held responsible for the financial representations of their companies. The bill therefore clearly establishes that the CEOs and CFOs are responsible for the presentation of material in their company's financial reports.''); *id.* at *23 (Sarbanes-Oxley ''includes provisions designed to prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public . . . .''). This congressional intent was most recently demonstrated with the Dodd-Frank Wall Street Reform and Consumer Protection Act, which made explicit that the SEC has enforcement authority to bring actions under 20(a). Dodd-Frank § 929P(c).

[18] *Pursuit of Individuals in Corporate Misconduct Still Arduous*, N.Y. Times, Sept. 22, 2014, *available at* http://dealbook.nytimes.com/2014/09/22/pursuit-of-individuals-in-corporate-misconduct-still-arduous/?_php=true&_type=blogs&_r=0.

[19] *S.E.C. Vows More Use of a Little-Used Tool*, N.Y. Times, May 27, 2014, *available at* http://dealbook.nytimes.com/2014/05/27/s-e-c-vows-more-use-of-a-little-used-tool/?_r=0 (quoting Chairwoman White as saying: ''One new approach to charging individuals is to use Section 20(b) of the Exchange Act'').

[20] Press Release, *Justice Department Recovers $3.8 Billion from False Claims Act Cases in Fiscal Year 2013*, U.S. Dep't of Justice (Dec. 20, 2013), *available at* http://www.justice.gov/opa/pr/justice-department-recovers-38-billion-false-claims-act-cases-fiscal-year-2013.

[21] Press Release, *Justice Department Announces Largest Health Care Fraud Settlement in its History*, U.S. Dep't of Justice (Sept. 2, 2009), *available at* http://www.justice.gov/opa/pr/justice-department-announces-largest-health-care-fraud-settlement-its-history; *see also* Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and Pfizer Inc., *available at* http://oig.hhs.gov/fraud/cia/agreements/pfizer_inc_08312009.pdf.

[22] Pfizer, Inc., Notice of Annual Meeting of Shareholders and Proxy Statement and 2009 Financial Report, Mar. 16, 2010, at 66, *available at* http://www.pfizer.com/files/annualreport/2009/proxy/proxy2009.pdf.

[23] Press Release, *Johnson & Johnson to Pay More Than $2.2 Billion to Resolve Criminal and Civil Investigations*, U.S. Dep't of Justice (Nov. 4, 2014), *available at* http://www.justice.gov/opa/pr/johnson-johnson-pay-more-22-billion-resolve-criminal-and-civil-investigations. Notably, the corporate integrity agreement included clawback provisions, though

Conclusion

Experience with the FCA suggests that additional statutory provisions expanding the potential reach of judgments and damages to include corporate executives could be of significant benefit toward the goal of deterring corporate violations. This conclusion holds particularly true in cases of large scale violations wherein executives in a position to prevent FCA violations of which they are aware knowingly choose not to, while at the same time they receive personal financial benefits made possible by the fruits of these illegal acts. The securities laws provide a useful example of how statutory provisions could create a presumption of liability for control persons that require those executives to demonstrate that they acted in good faith, could mandate individual certification requirements or could authorize a clawback of executive compensation in the wake of a settlement with the government. Each of these provisions would be an effective means of deterring corporate violations of the FCA.

Strengthening the ability of the government and whistleblowers to hold top corporate executives accountable for FCA violations is a worthy goal and one which will help ensure that the FCA is properly armed to punish and deter behavior that harms the government. It is typically in the wake of either a financial crisis (i.e., the Great Depression, the Financial Crisis of 2008) or widespread fraud (i.e., the accounting scandals of the Enron era) that the political will emerges to reexamine whether the current regulatory landscape contains adequate tools for policing corporate activities. It would serve our country well to consider incorporating into the FCA now the mechanisms already in place within the federal securities laws that hold corporate executives personally responsible for corporate misdeeds, rather than waiting for one of these unfortunate circumstances to inevitably recur.

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they were limited to situations in which the corporate executives were personally involved in ''significant misconduct.'' Corporate Integrity Agreement Between The Office of Inspector General of the Department of Health and Human Services and Johnson & Johnson, Appx. D, *available at* https://oig.hhs.gov/fraud/cia/agreements/Johnson_Johnson_10312013.pdf.

[24] CEO Alex Gorsky received $16.91 million in 2013 and $10.98 million in 2012. Johnson & Johnson 2014 Schedule 14A at 52; Johnson & Johnson 2013 Schedule 14A at 52.