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CIVIL AND CRIMINAL LIABILITY OF CORPORATE OFFICERS AND DIRECTORS

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You asked for a summary of federal and state civil and criminal liability that corporate officers and directors are subject to.

SUMMARY

The principle areas of civil and criminal liability corporate officers and directors face involve fraud and other misconduct in connection with buying or selling securities, and in conducting the corporation's business. For the most part, state and federal jurisdiction overlap. Federal jurisdiction depends on a connection with interstate commerce. But this is not much of an impediment

since most transactions involve, to some extent at least, the use of a phone, computer, or some other instrumentality of interstate commerce.

Federal criminal penalties of general applicability are substantial, especially in light of legislation Congress enacted during the past few months. For example, a corporate director or officer commits mail fraud if he intentionally participates in a scheme to defraud someone of money or property and uses mail or interstate wire communications to do so. The penalty is imprisonment for up to 20 years and a fine of up to $250,000. Other federal crimes of general applicability include bank fraud, conspiracy to commit a federal offense, fraud and false statements in connection with matters within the federal government's jurisdiction, destruction or falsification of records in connection with federal investigations, attempts and conspiracies to commit criminal fraud offenses, tampering with a record or otherwise impeding an official proceeding, and health care fraud,.

In addition, corporate officers and directors are also subject to federal laws that explicitly regulate the initial and subsequent sale of securities by publicly traded companies. The two principal federal securities laws are the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act deals primarily with the initial issuance of securities, and the Exchange Act regulates trading in securities after their initial issue. Congress has authorized the Securities and Exchange Commission (SEC) to enforce these laws. Corporate directors, officers, and others who violate these laws are subject to criminal penalties, administrative fines, civil penalties, cease and desist orders, injunctions, disgorgement (an equitable remedy to provide restitution to defrauded members of the public), private lawsuits, and orders barring them from acting as officers or directors of public companies.

One of the most relied upon federal laws is the anti-fraud prohibition of the Exchange Act. This prohibition, commonly referred to as Rule 10(b)-5, makes it unlawful for anyone, directly or indirectly, to engage in any act, practice, or course of business that operates, or would operate as a fraud or deceit upon anyone in connection with the purchase or sale of any security. It is used against many types of fraudulent conduct, including “insider trading.” This occurs when a director or officer (or other insiders) buys or sells stock in a publicly traded company based on material, non-public information.

Corporate officers and directors are also subject to criminal and civil penalties under state law. Criminal laws of general applicability, such as larceny, are used against corporate directors and officers who wrongfully obtain or withhold property with the intent to deprive someone of it or appropriate it for them or someone else. Larceny includes embezzlement, obtaining property by false pretense, and obtaining property by false promise. The penalty generally depends on the value of the property taken with a maximum penalty of 20 years in prison. Another example of a generally applicable crime is forgery,

which includes issuing forged stock, bonds, or other instruments representing interests or claims against a corporate or other organization or its property. The maximum penalty is 10 years in prison. A third example is making a false statement in the second degree, which involves making a false written statement in a statutorily authorized or required form to a public official in the performance of the official's duties. The maximum penalty is a year in prison.

Just as with federal law, state law contains requirements and prohibitions that explicitly deal with the sale of securities. The law authorizes the banking commissioner to enforce these laws. It empowers him to issue cease and desist orders, require restitution or disgorgement, and impose civil penalties of up to $10,000 for each violation. In addition, violators are subject to criminal penalties of up to 10 years in prison for defrauding investors. State law also authorizes private lawsuits for damages resulting from a violation of the state's securities laws including the right to recover costs and reasonable attorneys' fees.

State law also contains anti-fraud prohibitions in connection with the sale of business opportunities. It empowers the banking commissioner to enforce the prohibitions and provides an array of criminal and civil remedies similar to those provided by the state securities law to be used against violators.

In addition to these state civil and criminal remedies, directors and officers also are subject to private lawsuits, which may be filed directly against the director or officer, or may be filed by shareholders on behalf of the corporation (derivative lawsuits). Typically private lawsuits allege that the director or officer breached some duty he owed to the corporation or shareholders, violated some federal or state law, or engaged in some other misconduct.

Although liability in such suits may be potentially very high, the law allows, and sometimes requires, corporations to indemnify the director or officer for their expenses and losses. It also allows corporations to purchase liability insurance to cover these losses and expenses.

There are three other areas of liability that may expose corporate directors and officers to liability—pension fraud, workers' compensation fraud, and environmental protection violations.

If a corporate officer or director defrauds a private employee pension fund, he is subject to federal, but not state, penalties because the federal Employee Retirement Security Act (ERISA), which apparently supercedes state law (20 USCA § 1144(a)). The federal Department of Labor, the Internal Revenue Service, and the Justice Department investigate possible violations of private pension plans. The Justice Department may prosecute criminal charges regarding abuse or theft of pension funds (see OLR Report 2002-R-0670 for a more thorough discussion).

State workers' compensation law provides criminal penalties if a corporate officer knowingly and willfully fails to comply with statutory requirements that he prove to the Workers' Compensation Commission his solvency to provide proper compensation to employees (CGS § 31-288(f)). The maximum penalty for a violation is up to five years in prison.

Corporate officers and directors may be personally liable for violation of Connecticut's water pollution laws if:

1. they were in a position of responsibility that allows them to influence corporate policies or activities;

2. there is a connection between their position and the violation such that they could have influenced the corporate actions that constituted the violations; and

3. their actions or inactions facilitated the violations (*BEC Corp. v. Dept. of Environmental Protection*, 256 Conn. 602 (2001); CGS § 22a-432).

Corporate officers have also been held liable personally for violations of the Federal Clean Water Act (*United States v. Gulf Park Water Co.* 972 F Sup. 1056, 1064 (S.D. Miss 1997)). These principles of individual liability, known as the responsible corporate officer doctrine, may also apply in the context of other state and federal environmental protection laws.

Because of the breadth of the subject matter involved in your question and because of the recent focus on corporate liability in connection with securities transaction and corporate governance, our report focuses on these areas. Please let us know if you would like additional information concerning the liability of corporate officers and directors in connection with pension fraud, workers compensation, and environmental protection matters.

Also, there may be other state and federal laws that might expose corporate officers and directors to civil and criminal liability under certain circumstances.

FEDERAL CRIMES OF GENERAL APPLICABILITY

Mail Fraud and Wire Fraud (18 USCA §§ 1341 & 1343, as amended by PL 107-204, Section 903)

A person commits mail or wire fraud when he intentionally participates in a scheme to defraud another person of money or property and uses mail or interstate wire communications in furtherance of that scheme. To prove mail and wire fraud, the government must prove, beyond a reasonable doubt: (1) the defendant knowing and willingly participated in the scheme or artifice to defraud with specific intent to fraud, and (2) use of the mails or interstate wire communications in furtherance of that scheme. The penalty is imprisonment

for up to 20 years and a fine of up to $250,000. But if a financial institution is involved the penalty is imprisonment of up to 30 years and a fine of up to $1,000,000.

Bank Fraud (18 USCA § 1344)

A person commits bank fraud when he knowingly executes, or attempts to execute, a scheme (1) to defraud a financial institution; or (2) to obtain any of the monies, funds, credits, assets, securities or other property the financial institution owns, or has custody or control of, by means of false or fraudulent pretenses, representations, or promises. The penalty is a fine of up to $1,000,000, imprisonment of up to 30 years, or both.

Conspiracy To Commit An Offense Or To Defraud The United States (18 USCA § 371)

This offense occurs if two or more people conspire either to commit a federal offense, or to defraud the United States, or any agency of the United States in any manner or for any purpose, and at least one of the people commits some overt act towards the commission of this crime. If the offense that is the subject of the conspiracy is a felony the crime is punishable by a fine of up to $250,000, up to five years in prison, or both. If the offense is a misdemeanor, the punishment for the conspiracy may not exceed the maximum punishment provided for the misdemeanor, which is the object of the conspiracy.

Fraud And False Statements (18 USCA § 1001)

A person commits this offense when, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the United States government, he knowingly and willfully (1) falsifies, conceals, or covers up by any scheme or device of a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry. The penalty is up to five years in prison, or a fine of up to $250,000, or both.

Destruction, Alteration, Or Falsification Of Records In Federal Investigations And Bankruptcy

(PL 107-204, Section 802; 18 USCA § 1519)

It is a crime for someone to knowingly alter, destroy, conceal, falsify, or make a false entry in any record, document, or other object with the intent to impede, obstruct, or influence the investigation or administration of any matter within the jurisdiction of any United States department or agency or any case filed under the federal bankruptcy law. The penalty is up to 20 years in prison, a

fine of up to $250,000, or both. If the defendant is an organization, the fine may be up to $500,000 (18 USCA, 3571).

Attempts And Conspiracies To Commit Criminal Fraud Offenses (Pl 107-204,Section 902; 18 USCA § 1349)

Anyone who attempts or conspires to commit any of the following fraud offenses is subject to the same penalties as those who violate those offenses (mail fraud, bank fraud, health care fraud, and securities fraud; see 18 USCA §§ 1341-1347, as amended by PL 107-204).

Tampering With A Record Or Otherwise Impeding An Official Proceeding (PL 107-204 § 1102; 18 USCA § 1512)

It is a crime for someone to corruptly (1) alter, destroy, mutilate, or conceal a record, document, or other object, or attempt to do so, with the intent to impair its integrity or availability for use in an official proceeding or (2) otherwise obstruct, influence, or impede any official proceeding, or attempt to do so. Those who violate this provision are subject to imprisonment for up to 20 years, a fine of up to $250,000, or both (See 18 USCA § 3571).

Money Laundering (18 USCA § 1956)

Someone commits the crime of money laundering when he takes part in financial transaction knowing that 1) property involved includes the proceeds of illegal activity and 2) the transaction is designed to conceal or disguise the nature, source, location, ownership, or control of the illegal proceeds, or to avoid a transaction reporting requirement under state or federal law. An offender may be fined up to $500,000 or twice the value of the money involved in the transaction, or imprisoned up to 20 years, or both.

Health Care Fraud (18 USCA § 1347)

A person commits health care fraud when he knowingly and willfully executes, or attempts to execute, a scheme (1) to defraud any health care benefit program; or (2) to obtain by means of false or fraudulent pretenses, a representations, or promises, any of the money or property owned by, or under the custody or control of, any health care benefit program, in connection with the delivery of or payment for health care benefits, items, or services. The penalty is imprisonment for up to 10 years, or a fine of up to $250,000, or both. If the violation results in serious bodily injury, the offender is subject to a prison term of up to 20 years. If the violation results in death, the person may be imprisoned for any term up to life.

THE SECURITIES ACT OF 1933 (USCA SECTIONS 77A ET. SEQ.)

Overview

The Securities Act of 1933 (hereafter referred to as the Securities Act) attempts to protect the investing public by means of mandatory disclosure. It requires that, before a security can be offered for sale in interstate commerce, the issuer must file with the SEC a registration statement. The statement must contain specific information regarding the security, the issuer, and the underwriters. The law requires this information be made available to the public, and also requires that buyers be provided with a prospectus containing this essential information required to be included the registration statement.

The law does not authorize the SEC to determine what securities may or may not be distributed to the public. Rather, it has the duty to see that the required disclosure is made before distribution. It can prevent securities from being distributed when the disclosure requirements are not met by preventing or suspending the effectiveness of the issuer's registration statement. Criminal or civil sanctions may be imposed for material misstatements or omissions in connection with the registration statements. The Securities Act has general antifraud provisions. Violations of these provisions may subject the offender to criminal or civil liability and permit the SEC to obtain an injunction.

Registration Process

As previously noted, no security may be sold in interstate commerce, unless a registration statement has been filed for it. In fact, under the Securities Act of 1933, prior to a sale of such a security the registration statement not only must have been filed but also become effective. The process begins when a registration statement is filed with the SEC by the stock issuer. The statement must contain considerable disclosure about the issue and the issuer. The issuer cannot actually sell the securities until the statement becomes effective. Normally the statement becomes effective 20 days after it is filed. During the 20-day period, the SEC staff reviews the registration statement to make sure that all required information is disclosed. If there are shortcomings, the SEC staff notifies the issuer's lawyers of the problem in one or more letters of comments, which are also known as deficiency letters. The SEC has the power to act affirmatively to delay or suspend the effectiveness of a registration statement. It can issue a refusal order to prevent the statement from becoming effective or a stop order to suspend the effectiveness of an already-effective registration statement.

For a registration statement to be complete, it must include the price at which the securities will be offered to the public. The SEC does not conduct an independent investigation into the truth of matters disclosed in the registration statement. The SEC staff does inspect the documents to see whether they appear to be complete and accurate on their face. But the staff does not look into other sources of information. (USCA §§ 77f-77j). Thus, in the event of a

later civil lawsuit for falsifying the registration statement, the issuer may not raise as a defense that the SEC reviewed the statement and found it accurate (see 15 USCA §§ 77e, 77h, and the *Emanuel Law Outlines on Corporations* at pp. 596-597).

The act makes it unlawful for anyone to represent to any prospective purchaser that the SEC has concluded that a registration statement is true and accurate on its face or that it discloses all material facts (15 USCA §77w). It also makes it unlawful for anyone to sell an unregistered security or use a prospectus that does not meet the act's requirements (15 USCA § 77e).

Exemptions From The 1933 Act

The Securities Act, and regulations adopted by the SEC under it, contains exemptions from the registration requirements for offers and sales for securities where the issuer, the securities, or the transaction meet certain requirements. The exemptions are contained in §§ 3 and 4 of the Securities Act (15 USCA §§ 77c and 77d). The exemptions are of two general types—securities and transactional. Securities exemptions result in the securities being deemed to be exempt from registration regardless of the seller or the purchaser's identity. Transactional exemptions result in the sale of securities in connection with a specific transaction being exempt from registration but not do cover other sales of such securities, such as resale by people receiving the securities or sale of securities other than those specified in the exemption (69 Am. Jur. 2nd Securities Regulation-Federal §93). The Securities Act authorizes the SEC to create additional exemptions from registration and allows the SEC to create circumstances in which the claim of exemption from registration will be presumed valid. The law authorizes the SEC to exempt any class of securities from registration where (1) the aggregate amount of the offering does not exceed $5 million and (2) the SEC finds the enforcement of the Securities Act is unnecessary in the public interest and for the protection of investors based on the small amount involved or the limited character of the public offering (15 USCA §77c (b)).

One of the exemptions under the Securities Act applies to intrastate issues. Under this exemption, any security that is part of an issue offered and sold only to residents within a single, where the issuer of the security also is a person residing and doing business in that state or, if the issuer is a corporation, incorporated and doing business within that state, is exempt from registration under the Securities Act (15 USCA § 77(c)(a)(11)).

Using its authority to establish safe harbor exemptions from registration, the SEC adopted Rule 147, which established requirements that presumptively establish the existence of the intrastate offering exemption from registration. It establishes specific requirements and quantitative criteria for issuers seeking the added certainty that the intrastate exemption is available. The safe harbor

of the rule is available only for offerings by the issuer. The issuer must be a resident of and doing business within the state in which all offers and sales are made and no part of the issue may be offered or sold to nonresidents within the period of time specified in the rule (17 CFR § 230.147; 69 Am. Jur. 2nd Securities Regulation-Federal § 111).

Issuers, Underwriters, And Dealers

The Securities Act focuses on people engaged in certain transaction involving publicly traded securities. These people include issuers, underwriters, and dealers.

Under the Securities Act, a person is an "issuer" if he issues or proposes to issue any security (15 USCA §77b (4)). Since this term encompasses those who propose to issue any security, it includes those who promote the sale of a business not yet in existence.

The Securities Act defines "underwriter" as anyone who (1) has purchased from an issuer with the intention to distribute the security; (2) offers or sells for an issuer in connection with a distribution of a security; (3) participates or has direct or indirect participation in this purchase from the issuer with the intent to distribute the securities; (4) participates or has a direct or indirect participation in the offer or sale for an issuer in connection with the distribution of any security; or (5) participates or has a participation in a direct or indirect underwriting of the distribution of any security (15 USCA § 77b (11)).

Anyone participating in underwriting is an underwriter for purposes of the Securities Act, even though he is not the principal underwriter. Thus, each member of a chain of people, the first of which purchases securities from the issuer and the last of which sells them to the investing public is an underwriter for purposes of the Securities Act (69 Am. Jur. 2nd Securities Regulation-Federal § 73).

Under the Securities Act, the term "dealer" means anyone who engages, either for all or for part of his time, directly or indirectly, as an agent, broker, or principal in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person (15 USCA § 77b (12)). While some other federal laws distinguish between a dealer and a broker, the Securities Act does not. For example, the Exchange Act considers a dealer as one who buys and sells securities for his own account, whereas a broker is one who engages in securities transactions for someone else's account. The Securities Act on the other hand includes all people dealing in securities whether they do so for their own account or as a broker on someone else's behalf (69 Am. Jur. 2nd Securities Regulation-Federal §74).

Civil Liability Under the 1933 Act

The Securities Act contains four provisions authorizing individuals who are harmed to file lawsuits. The most significant may be 15 USCA § 77k, which imposes liability for false statements in a registration statement. A second provision (15 USCA § 77l (1)) imposes liability on anyone who offers or sells a security in violation of the registration requirements of the act. Its main use is with respect to unregistered

stock. The act makes anyone who controls someone who is liable under either provision liable jointly and severally with and to the same extent as the controlled person (15 USCA § 77o).

A third provision is a general anti-fraud section. Under 15 USCA § 77l (2), an injured party can file a lawsuit if a security seller presents an untruth orally or in writing in connection with a sale. This provision covers offerings that are exempt from registration as well as those that are covered by the registration requirement. The final provision (15 USCA § 77q) is also a general, anti-fraud provision. It also applies whether or not registration is required. Thus, this provision can apply to sales of securities that are exempt from the registration requirement. Whereas the first anti-fraud provision described above applies only to statement or omission, this provision applies to any device, scheme, or artifice to defraud. It does not appear that people can file a lawsuit based on a violation of this provision. Rather, enforcement would be through the SEC and the various enforcement mechanisms it enjoys.

We have described these provisions in more detail below.

False Statements in a Registration Statement. Under this provision, if a registration statement, at the time it becomes effective, contains an untrue statement of a material fact or omitted to state a material required to be stated or necessary to make the statement not misleading, anyone who buys the stock may sue the issuer as well as a number of other people (15 USCA § 77k).. Thus anyone who bought the stock covered by the registration statement is authorized to file a lawsuit by this provision. Thus the person bringing the lawsuit does not have to be someone who bought at the initial public offering; he can be a secondary buyer, that is one who bought from one bought at the initial offering.

The plaintiff does not have to show he relied on the registration statement. But the section gives the defendant an affirmative defense. He can avoid liability if he can prove the plaintiff/purchaser knew of the untruth or omission at the time he purchased the stock. Furthermore, if the plaintiff bought the stock after the issuer made public an earnings statement covering the first twelve months of operations following the effective date of the registration, then the

plaintiff must prove that he in fact relied on the registration when made his purchase.

This provision allows the following people to be sued:

1. everyone who signed the registration, which includes at least the issuer, the principal officers, and the majority of the directors;

2. everyone who was a director at the time the registration statement was filed or who was named with his consent in the statement as being about to become a director;

3. every expert who consented to being named as having prepared or certified a part of the registration statement, including accountants, engineers, and appraisers; and

4. every underwriter.

The issuer's liability is absolute. Even if the misstatement or omission was inadvertent, the issuer is nonetheless strictly liable. But the other defendants can raise a due diligence defense. This allows defendants who can show that they exercised due diligence in connection with the registration statement to escape liability. This test is applied differently with respect to portions of the statement prepared by experts and those portions not prepared by experts.

The measure of damages in a lawsuit filed under this provision is the difference between the price the plaintiff paid for the stock and the value of the stock at the time of the lawsuit. Thus the measure of damages essentially covers the plaintiff's out-of-pocket loss. But the defendant may get the damages reduced by showing that the decline in the value was caused by factors other than the error in the registration statement.

Liability for Selling an Unregistered Security. 15 USCA § 77l(1) imposes liability on anyone who sells a security that should have been registered but was not. Liability under this provision is strict. Even if the seller made an honest mistake and a non-negligent mistake in concluding that the stock did not need to be registered he is nonetheless liable. The stock buyer who files the lawsuit may only sue the person who sold it to him as opposed to someone further back in the sale chain. The plaintiff is allowed to collect damages equal to the difference between what he paid and what the stock was worth at the time of the lawsuit or the amount he received when he resold it.

Untrue Statements or Omissions of Material Facts. 15 USCA § 77l(2) establishes liability for untrue statements of material facts or for omissions of material facts. This liability is not limited to misstatements made in the registration statement. It imposes liability for misstatements made orally or in

writing other than the registration statement. It also applies regardless of whether the security is registered or required to be registered.

This provision in essence imposes a negligence standard. It gives the seller a defense if he can show that he did not know, and in the exercise of reasonable care, could not have known, of the untruth or omission. This provision allows the buyer to sue anyone who was a substantial factor in the sale. The defendants are not limited to the stock sellers. Thus, others such as brokers who handle the transaction as a seller's agent might be liable if they made an untrue statement or material omission in connection with the sale.

The General Anti-Fraud Provision. 15 USCA § 77q makes it unlawful in the offer or sale of any security to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any untrue statement of a material or any omission to state a material fact or to engage in any transaction that operates or would operate as a fraud or deceit upon the purchaser. (This provision is almost identical in what it prohibits to a provision in the Exchange Act and a rule adopted under the Exchange Act.) But unlike the previous three provisions that contain an explicit private right of action, this provision is silent as to whether or not an injured party can file a lawsuit under it. Most recent cases on the subject appear to hold that there is no private right of action under this provision. Thus it appears that enforcement would be through the SEC rather than by a private lawsuit.

THE EXCHANGE ACT (15 USCA SEC. 78 ET. SEQ.)

Overview

The Securities and Exchange Act of 1934 (hereafter referred to as the Exchange Act) deals with securities sold after their initial issuance. It was enacted for several reasons including to (1) regulate transactions by officers, directors, and principals security holders; (2) outlaw the use of insider information for the financial gain of privileged insiders to the detriment of uninformed security holders; (3) make information more available to people trading in securities on the markets; and (4) ensure through regulation and self-regulation the maintenance of fair and honest markets in transactions conducted on securities exchanges and on over the counter market through the prevention of fraud and manipulation of the securities market (69 Am. Jur. 2nd Securities Regulation-Federal §301).

The Exchange Act requires that all brokers and dealers, unless otherwise exempted, and all stock exchanges must register with the SEC. It authorizes the SEC to expel member broker-dealers from exchanges and to revoke or suspend the registration of broker-dealers for violating its provisions. The act also provides for the formation of “national securities associations” of brokers or dealers as self-regulatory organizations. These associations are subject to

the SEC's supervision, and the SEC may expel or suspend members if they violate the Exchange Act. A stock issuer must register with both the stock exchange and the SEC in order for its securities to be listed on the exchange. In doing so, the issuer must provide information that is substantially the same as that which is required for the initial issuance of stock under the Securities Act. Brokers and dealers as well as exchanges must keep information required to be filed current by filing regular reports. In addition to these specific disclosure requirements, the Exchange Act contains several general anti-fraud provisions that prohibit fraud and manipulation in the securities markets, including certain specific practices that may permit insiders or so-called "control people" to profit unfairly at the expense of lesser-informed investors. Violation of these anti-fraud provisions subject the violators to civil enforcement by the SEC as well as criminal and civil liability.

Prohibitions Under the Exchange Act

The act makes it unlawful:

1. to conduct stock transactions on unregistered exchanges (15 USCA § 78e);

2. to engage in certain actions to manipulate the market for securities (15 USCA §78i);

3. for members, brokers, and dealers to trade for their own account or an associated person's account (15 USCA § 78k);

4. for broker-dealers to extend credit for new issues and the failure of broker-dealers to disclose the agency or principal relationship involved in each transaction (15 USCA § 78k(d));

5. to make untrue statements in connection with a tender offer (15 USCA § 78n(e));

6. for an unregistered broker or dealer to offer to sell a security (15 USCA § 78o);

7. for a broker or dealer to use certain manipulative or deceptive devices concerning the broker's or dealer's financial responsibilities (15 USCA § 78o);

8. or any director or officer to hinder, delay, or obstruct the making or filing of reports under the Exchange Act (15 USCA t(c);

9. to represent that the SEC has approved or passed on the merits of an act, document, or transaction (15 USCA §77w);

10. to use any manipulative device in violation of SEC rules (15 USCA 78j);

11. to make certain short-swing trading profits (15 USCA 78p); and

12. to engage in certain activities involving foreign, corrupt practices (15 USCA §§78dd-1, 78dd-2).

The Exchange Act authorizes private lawsuits for market manipulations, and for false statements and documents filed under the Exchange Act (15 USCA §78i (e), and 78r). It also makes people jointly and severally liable with the people they control, unless the controlling person acted in good faith and did not induce the violation (15 USCA §78t(a)). It creates a private right to sue against people purchasing or selling securities while in possession of material, nonpublic information (15 USCA §78t-1). This is called insider trading and we will deal discuss this in greater detail in a subsequent section of this report. It provides for criminal and civil penalties for violation of the Exchange Act (15 USCA §78ff).

Scope of the Exchange Act

The meaning of the word "security" under the Exchange Act is the same as under the Securities Act, even though the literal definitions are worded slightly differently (*Reeves v. Earnest & Young*, 494 US 56; 69 Am. Jur. 2nd Securities Regulation-Federal §321).

Certain securities are exempted from the Exchange Act. These include:

1. securities representing governmental obligations;

2. securities, the obligations of which are guaranteed by the federal, state, or local governments;

3. securities of certain corporate issuers in which the U.S. has an interest, as designated by the Secretary of the Treasury; and

4. interests or participations in certain common trusts or similar funds maintained by banks exclusively for specified purposes, including employee benefit plans (69 Am. Jur. 2nd Securities Regulation-Federal § 322).

The Exchange Act defines the term "broker" to mean anyone engaged in the business of affecting transactions in securities for the account of others, and defines the term "dealer" to be anyone engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include someone who acts in such a manner otherwise than as a part of a regular business. Apparently, most firms act both as dealers, or "principals" and as brokers, or agents. The term broker-dealer is commonly used to describe such a brokerage firm. Many such firms perform other functions for issuers, brokers, and customers, such as the provision of investment advice,

market advice, and underwriting arrangements. These firms are also known as "investment bankers." The commonly used terms "stock broker" is usually used to refer to someone associated with a brokers firm in an employee capacity. These are the people who have direct contact with the firm's customers. For the most part, the Exchange Act regulates brokers and dealers in a similar manner. One exception is 15 US Code CA §78o (c)(5). This prohibits dealers from affecting or inducing securities transactions in violation of SEC rules adopted to maintain fair and orderly markets or to remove impediments to and perfect the mechanism of a national market system. This rule also authorizes the SEC to prohibit a dealer in the security from acting as a broker in that security (69 Am. Jur. 2nd Securities Regulation-Federal § 329).

A person is an "associated person" of a broker-dealer if he is a partner, officer, director, or branch manager of the broker-dealer or if he, directly or indirectly, controls, is controlled by, or is under common control with the broker-dealer, or is an employee of the broker-dealer. But employees of broker-dealers whose functions are solely clerical or ministerial are excluded from the definition of "associated person" for the purposes of registration.

There appears to be some confusion as to whether people commonly known as "finders" fall within the definition of broker-dealer or of associated person. In several instances, the SEC has confirmed that many people who refer potential customers to broker-dealers are not regulated under the Exchange Act, except under the anti-fraud provision. Ultimately, whether or a finder has to register as a broker-dealer or as an associated person depends on the precise circumstances involved (69 Am. Jur. 2nd Securities Regulation-Federal § 329).

Anti-Fraud Provision—Rule 10(b)-5

Section 10(b) of the Securities Exchange Act provides the basis for one of the most relied upon anti-fraud provision in the federal securities laws. It provides, "it is unlawful for anyone, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange to use in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest for the protection of investors."

Pursuant to this authority, the SEC enacted rule 10(b)-5 in 1942. Under this rule, it is unlawful for anyone, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mail, or of any facility of any national securities exchange to,

1. employ any device, scheme, or artifice to defraud;

2. make any untrue statement of a material fact or to omit to state material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

3. engage in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon anyone in connection with the purchase or sale of any security.

Rule 10(b)-5 prohibits any fraud or deceit in connection with the purchase or sale of any security. Thus certain misrepresentations and omissions, may constitute a violation of this rule even though the situation does not fall within the conventional pattern of someone who buys or sells based on non-public information about the company whose shares are being traded.

For example, if an insider such as a director, officer, or controlling shareholder, lies to the board of directors or the compensation committee and induces them to sell him stock on favorable terms Rule 10(b)-5 is violated even though the trade takes places directly with the corporation (*SEC v. Texas Gulf Sulphur Company*, 401 F2d 833 (2d Cir. 1968)). If the insider violates his fiduciary duties to the corporation but the violation does not involve any misrepresentation or any nondisclosure of something he is obligated to disclose, the breach of fiduciary duty by itself appears not to be a violation of Rule 10(b)-5 (*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977)).

The rule also seems to apply to misrepresentations without trading on the part of the one who misrepresented. Thus someone who knowingly issues a false or misleading public announcement will be liable under rule 10(b)-5 for all damages caused to someone who buys or sells the company stock in reliance on the false statement (*Mitchell v. Texas Gulf Sulphur Co.*, 466 F. 2d 90 (10th Cir. 1971)).

Required State of Mind. Someone is liable under Rule 10(b)-5 only if he acted with intent to deceive, manipulate, or defraud (Ernst and Ernst v. Hochfelder, 425 US 185 (1976)). If a defendant misstates a material fact knowing that the statement is false, and with intent that the listener rely on the misstatement, the requirement is met. If the representation is made without any belief as to whether it is true or not, this also probably constitutes a required state of mind. And if someone makes a misstatement recklessly, most courts have concluded that this satisfies the required state of mind for purposes of a Rule 10(b)-5 lawsuit (Emanuel Law Outlines, Corporations p. 299).

Limited Express Right of Action Under Rule 10(b)-5. Congress amended the Exchange Act in 1988 to provide for an express private right of action under limited circumstances (15 USCA § 78t-1). Under this provision anyone who violates any part of the Exchange Act or rules or regulations adopted under it by buying or selling a security while in possession of material, non-public

information is liable to anyone who, contemporaneously with the purchase or sale of the securities that is the subject of the violation, has purchased or sold securities of the same class. The total amount of damages may not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation. And the total amount of damages imposed against anyone under this provision must be diminished by the amount the person may be required to disgorge, pursuant to a court order obtained at the request of the SEC at a proceeding relating to the same transaction or transactions.

Insider Trading

Rule 10b-5 applies to any form of deceit or fraud, including cases of insider trading. A person engages in "insider trading" if he buys or sells stock in a publicly traded company based on material non-public information about that company (*Corporate Law* by Robert Clark, p. 264). For example, insider trading occurs when a high company official

learns of some favorable development concerning his company, and buys stock in the company before this good news is disclosed to the public. It may also take the form of selling before the disclosure of bad news about the company's prospects.

Rule 10(b)-5 applies to cases in which the insider silently buys or sells on material non-public information and thus never makes any affirmative misrepresentation. It also applies to someone who makes a misrepresentation that induces others to buy or sell, even if the maker of the misrepresentation never buys or sells himself. And, investors who meet certain procedural requirements may bring a private lawsuit alleging a violation of Rule 10(b)-5 and may recover damages for that violation, even though the rule itself does not explicitly provide for a private right of action (*Superintendent of Insurance v. Bankers Life and Casualty Company*, 404 US 6 (1971)).

An inside trader will be found to have violated Rule 10(b)-5 if all of the following elements are present:

1. he bought or sold stock in a company whether or not it is a publicly traded company;

2. at the time he bought or sold the stock, he was in possession of information that was material;

3. this material information was non-public at the time he bought or sold it; and

4. he had a special relationship with the source of the information, either the issuer or someone else who possessed insider information.

Someone meets this last requirement if he were a "true insider" of the issuer, that is an officer, director, or employee, or was a "constructive insider," that is in possession of confidential information that the issuer temporarily entrusted him with; such as an attorney working as outside counsel for the issuer. He also meets the requirement if he was given the information by an insider in violation of the insider's fiduciary duty. Finally, he meets this requirement if he was a "misappropriator" that is an outsider who got the information from someone other than the issuer in breach of a promise of confidentiality.

The misrepresentation or omission must be as to a "material" fact. In a lawsuit based on Rule 10(b)-5, a fact is material if there is a substantial likelihood a reasonable shareholder would consider it important in deciding whether to buy, hold, or sell the stock (*Basic, Inc. v. Levinson*, 485 US 224 (1988)).

Insider. The term insider is not defined by statute nor has it been given a precise meaning by the US Supreme Court. But it seems to encompass those that obtain information by virtue of their employment with the company whose stock is traded. Officers, directors, and high-level employees of a company clearly appear to be insiders and are liable under Rule 10(b)-5 if they trade in the company's stock while in possession of material, non-public information about their company. Even a low-level employee who learns information by virtue of his employment with the company also appears to be an insider (Diamond v. Oreamuno, 248 NE 2d 910 (1969)).

Civil Penalties for Inside Trading. In addition to damages a private person may recover in a lawsuit for insider trading, the SEC may also recover civil penalties against the inside trader (15 USCA § 78u-1). It authorizes the SEC to recover up to three times the profit gained or loss avoided by the inside trader. This also applies to anyone who has violated the Exchange Act or rules or regulations under it by communicating material, non-public information in connection with a transaction through the facilities of a national securities exchange or from or through a broker or dealer also liable under this provision. In addition, this provision allows the imposition of a penalty on any person who, at the time of the violation, directly or indirectly controlled the person who committed the violation. With respect to such control person, the penalty may not exceed $1 million or three times the amount of profit or loss avoid, which ever is greater. But a controlling person is not subject to this penalty unless the SEC proves that he:

1. knew or recklessly disregarded the fact that the person or entity he controlled was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent the act or acts before they occurred or

2. knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required by the exchange law and this failure substantially

contributed to or permitted the occurrence of the act or acts constituting the violation.

Pension Fund Blackout Requirements

Directors and officers may not buy, sell, or otherwise acquire or transfer company securities during a blackout period under a public company's individual retirement account retirement plans. The law defines a blackout period as any period of more than three consecutive business days during which the ability of at least 50% of the participants or beneficiaries under which all the company's individual retirement plans to buy, sell, or otherwise acquire or transfer an interest in any of the company's securities is temporarily suspended by the company or by a plan fiduciary. The law establishes some exceptions to this definition.

The company, or its shareholders may file a lawsuit to recover any gain a director or officer makes by violating this prohibition (PL107-204, Section 306(a)).

Short-Swing Trading Profits

Congress also enacted another law to combat insider trading (15 USCA § 78p (b)). This provision establishes a "bright line" rule to stamp out at least some types of insider trading. Under this provision, if a statutorily defined insider buys stock in his company and sells it at a profit within six months or sells it and repurchases for a lower price within six months he is automatically required to return the profits to the corporation, even if he had no insider knowledge. The provision applies to officers, directors, and anyone who is the owner of more than 10% of any class of the company's stock. This provision only applies to classes of stock registered with the SEC under the Exchange Act. This law allows the corporation or any shareholder to file suit. But even if a shareholder files the suit, any recovery goes into the corporate recovery, not to the shareholder. The provision does allow, however, attorneys' fees for the plaintiff's lawyer if the action is successful. The law requires insiders to file a statement showing their ownership in the company stock within 10 days after any calendar month in which that ownership changes. The SEC releases this information to the public, and private securities lawyers look at it to see if they were any illegal short-swing trades.

CRIMINAL PEALTIES FOR SECURITY LAW VIOLATIONS

The Securities Act Of 1933 (15 USCA § 77x)

A person commits this offense if he (1) willfully violates any of the provisions of the Securities Act, or the rules and regulations the securities and exchange commission adopts under authority of this act or (2) willfully makes any untrue

statement of a material fact or omits to state any material fact required to be stated or necessary to make the statement not misleading in a registration statement filed under this law. The penalty is a fine of up to $10,000, imprisonment of up to five years, or both.

Securities Exchange Act Of 1934 (15 USCA § 78ff as amended by PL: 107-204, Section 1106.)

The Exchange Act imposes criminal penalties on a person who (1) willfully violates any of its provisions; (2) willfully violates any rule or regulation under any provisions of the act the violation of which is made unlawful or compliance with which is required under the terms of the act or (3) willfully and knowingly makes, or causes to be made, any statement that is false or misleading concerning any material fact and is in any application, report, or document, required to be filed (a) under the exchange act, any rule or regulation under the exchange act, or any undertaking contained in a registration statement as provided by the exchange act, or (b) by any self regulatory organization in connection with an application for membership or participation in the organization or to become associated with a member of the organization. The penalty for this offense is a fine of up to $5,000,000, imprisonment for up to 20 years, or both. But when the defendant is a corporation or other business entity, rather than a human being, the fine may be up to $25,000,000. The law specifies that no one may be subject to imprisonment under this law for violating any rule or regulation if he proves he had no knowledge of the rule or regulation.

The Exchange Act also has a separate provision related to foreign trade practices by stock issuers (15 USCA § 78dd-1). It contains separate criminal penalties for violation of this law (15 USCA § 78ff(c)). Please let us know if you would like us to discuss these separate penalties for this type of offense.

Destruction Of Corporate Audit Records (PL 107-204, Section 802; 18 USCA § 1520)

Any accountant who conducts an audit of a company that issues stock and is subject to the Exchange Act (15 USCA § 78j-1(a)) must keep all audit or review work papers for five years from the end of the fiscal period in which the audit or review was concluded. An auditor who violates this requirement is subject to imprisonment for up to 10 years, a fine up of to $250,000, or both. The law requires the SEC to adopt regulations that are necessary to the retention of relevant records such as work papers, documents that form the basis of an audit or review, memoranda, correspondence, communications, and other documents and records.

Criminal Penalties For Defrauding Shareholders Of Publicly Traded Companies (PL 107-204,Section 807; 18 USCA § 1348)

A person commits the crime of securities fraud when he knowingly executes, or attempts to execute, a scheme to (1) defraud any person in connection with any publicly traded security or (2) obtain, by false or fraudulent pretenses, representations, or promises, any money or property in connection with the sale of any publicly traded security. This offense is punishable by imprisonment for up to 25 years, a fine of up to $250,000, or both. If the offender is an organization the fine can be up to $500,000 (See 18 USCA § 3571)

Failure Of Corporate Officers To Certify Financial Reports (Pl 107-204, 18 USCA § 1350)

Senior corporate officers (chief executive officers and chief financial officers, or their equivalents) must certify in writing that financial statements and related disclosures fully comply with the requirements of the Exchange Act and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of their business. A corporate officer who certifies any statement knowing the periodic statement accompanying the statement does not comport with all of the requirements set forth in the law are subject to a fine of up to $1,000,000, imprisonment up to 10 years, or both. Those corporate officers who do this willfully are subject to a fine of up to $5,000,000, imprisonment up to 20 years, or both. Neither this provision, nor the chapter it will be placed in, explicitly defines the word "willful" but apparently this term means to act with knowledge that one's conduct is unlawful and with intent to do something the law forbids, that is to act with the bad purpose of disobeying or disregarding the law (*Bryan v. US* 118 S. Ct. 1939 (1998)). Thus the word willful seems to focus on conduct that is deliberate and intentional as opposed to conduct based on negligence, inadvertence, or mistake (*US v. Mittal,* 26 Fed. App. 20, Second Circuit, June 10, 2002)

AUTHORITY OF SEC TO ENFORCE FEDERAL SECURITIES LAWS

The Exchange Act established the Securities and Exchange Commission (SEC). It authorized the SEC to conduct investigations, hold hearings, and adopt rules, regulations, orders, and annual reports. It makes information filed with the SEC available to the public. It

authorizes the SEC to issue cease and desist orders in connection with its enforcement powers (see 15 USCA §§ 78u-78y, §§ 78q-1 and 78q-2, and 15 USCA § 78u-3).

The Exchange Act requires all brokers and dealers, unless otherwise exempted, and all stock exchanges to register with the SEC. It authorizes the SEC to expel member broker-dealers from exchanges and to revoke or suspend the registration of broker-dealers for violating its provisions. The act also provides

for the formation of “national securities associations” brokers or dealers as self-regulatory organizations. These associations are subject to the SEC's supervision, and the SEC may expel or suspend members if they violate the Exchange Act. A stock issuer must register with both the exchange and the SEC in order for its securities to be listed on the exchange. In doing so, the issuer must provide information that is substantially the same as that which is required for initial issuance of stock under the Securities Act. Brokers and dealers as well as exchanges must keep information required to be filed current by filing regular reports. In addition to these specific disclosure requirements, the Exchange Act contains several general anti-fraud provisions that prohibit fraud and manipulation in the securities markets generally. They also prohibit certain specific practices that may permit insiders or so-called control people to profit unfairly at the expense of lesser-informed investors. Violation of these anti-fraud provisions subject the violators to civil enforcement by the SEC as well as criminal and civil liability.

The Securities Act and the Exchange Act authorize the SEC to conduct investigations to determine whether either act has been violated. The SEC does not have to show that a violation of these laws has occurred before it may begin its investigation. The scope of the SEC's investigations is not limited by the probable results of the investigation. The only general statutory limitation is that the information that the SEC requests must be deemed relevant or material to its inquiry. Unless the SEC otherwise orders, all its formal investigations are nonpublic. The SEC may conduct its investigations even where it has already referred the matter for criminal prosecution (69 Am. Jur. 2nd Securities Regulation-Federal §§ 1617 and 1618).

Sanctions Against Registered Persons

The law authorizes the SEC, after investigation and hearing, to take the following actions against brokers or dealers:

1. imposing censure;

2. placing limitations on their activities, functions, or operations;

3. suspending them for a period not exceeding 12 months; or

4. revoking their registration (15 USCA § 78o).

The law also authorizes the SEC to impose various sanctions on people associated with a member of a registered securities association. These sanctions include censure; suspension for a period not exceeding 12 months, or barring the person from being associated with a broker or dealer (15 USCA § 78o (b)(6)).

In order to impose such penalties, the SEC must find, on the record, the sanctions are in the public interest and that the individual that is the subject of the penalty has

1. willfully made or caused to be made in any application for registration or report any statements that at the time and in light of the circumstances under which they were made were false and misleading;

2. been convicted in the last ten years of any felony or misdemeanor related to certain offenses;

3. been permanently or temporarily enjoined from acting as an investment advisor, underwriter, broker, dealer, or municipal dealer or as an affiliated person or employee of such people or entities; or

4. willfully violated or aided and abetted in a violation of the federal securities laws (15 USCA § 78o (b) (6); 69 Am. Jur. 2nd Securities Regulation-Federal § 1691).

The law also authorizes the SEC, upon notice and hearing, to suspend the registration of a registered securities association for up to 12 months or to revoke the registration if it finds the association has (1) violated any provision of the Exchange Act, or any rule or regulation adopted under it, or (2) failed to enforce its own rules (15 USCA § 78s (h)(1)).

Administrative Fines

The law authorizes the SEC to impose a monetary penalty in an administrative proceeding instituted under the Exchange Act (15 USCA §78u-2). The fines the SEC can impose fall into one of three categories or tiers, depending on the nature and, in some instances, the impact of the violation on others. The first tier authorizes a fine of up to $5,000 for each act or omission if the offender is a person, or up to $50,000 for any offender that is a corporation or other business entity. The second tier penalty may only be imposed for acts or omissions that involve fraud, deceit, manipulation, or deliberate or reckless regard of a regulatory requirement. This fine may be up to $50,000 for a person or up to $250,000 for a corporation or any other business entity. The third tier penalty covers the same kinds of violations as the second tier covers. But these third tier penalties may be imposed if, in addition, the violation results in substantial losses or a significant risk of substantial losses to other people. The maximum fine under this tier is $100,000 for a person or up to $500,000 for a corporation or any other business entity.

In determining whether to impose a fine, the SEC must consider:

1. whether the violation included fraud, deceit, or something similar, and was committed willfully;

2. the harm resulting to other people;

3. prior securities violations;

4. the need to deter the alleged violator and other people from committing such violations; and

5. any other matters that justice may require (15 USCA §78u-2 (c); 69 Am. Jur. 2nd Securities Regulation-Federal §1696).

Financial Penalty for Failing to File Required Reports

The SEC may recover from an issuer, in a civil lawsuit filed in the name of the United States, $100 for each day the issuer fails to file information, documents, or reports required to be filed by the Exchange Act or any rule or regulation under the Exchange Act. Such a forfeiture is in lieu of a criminal penalty under the Exchange Act (15 USCA §78ff (b)).

Cease and Desist Orders

The SEC may administratively enter cease and desist orders restraining any violation or threatened violation of the securities laws (15 USCA §77h-1; 15 USCA §78u-3). Under this authority, if the SEC finds that anyone is violating, has violated, or is about to violate any provision of the securities laws, or any rule or regulation adopted under them, it may enter a order directing that person to cease and desist from committing or causing the violation. It may further order him to take specific steps to comply within such time as the SEC may order (15 USCA §§77h-1 (a) and 78u-3 (a)). The law also authorizes the SEC to enter an order requiring an accounting, disgorgement of any profit, and payment of reasonable interest (15 USCA §§ 77h-1(e) and 78u-3(e)(1)).

Injunctions

The securities laws authorize courts to issue injunctions to prevent violations or continued violations of provisions of the securities laws (15 USCA §§ 77t (b) and 78u (d)). The law authorizes the SEC to go to court to get such an injunction whenever it believes someone is engaged in, or is about to engage in, any acts or practices that constitute or will constitute a violation of the securities law. The law authorizes the SEC to also seek an injunction for violation of the rules of a national securities exchange or a registered securities association.

Disgorgement

Disgorgement is an equitable remedy designed to deter future violations of securities law and to deprive defendants of the proceeds of their wrongful conduct. It recognizes that issuance of an injunction, by itself, does not correct the consequences of past activities. The law allows a court to impose this remedy if it believes a defendant should not profit from his wrongdoing. Thus this remedy does not affect the right of private parties to file lawsuits. The law gives a court the discretion to appoint a trustee or escrow agent to take the disgorged funds, seek out defrauded members of the public, and offer them restitution. Disgorgement is remedial, not punitive, in nature. Thus a court may only order that the defendants restore, with interest, the amount of their profit. A court may not assess an amount that would be construed to be a penalty or a fine when using the remedy of disgorgement (69 Am. Jur. 2nd Securities Regulation-Federal §1708).

Civil Penalties

The law authorizes the SEC to go to court to seek the imposition of a civil penalty for any violation of the securities laws, or any rule or regulation promulgated under them or for a violation of one of the SEC's cease and desist orders. As previously noted, the law authorizes the SEC to impose administrative fines, but only on specified securities professionals. The law gives courts more power by authorizing them to impose civil penalties on any securities violator. As with administrative fines, the amount imposed as a civil penalty is based on a three-tier structure. Under the first tier the penalty may be up to $5,000 for an individual and up to $50,000 if the violator is a corporation or other business entity. Tier two civil penalties are for situations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. Under tier two, the civil penalty may be up to $50,000 for an individual and up to $250,000 for a corporation or other entity. The third tier covers the same type of behavior covered by tier two, but the violation must directly or indirectly result in the substantial loss or creates a significant risk of substantial losses to other people. The third tier permits a civil penalty of up to $100,000 for an individual and up to $500,000 for a corporation or any other business entity (15 USCA §§ 78u (d)(3) 77t(d); 69 Am. Jur. 2nd Securities Regulation-Federal § 1710).

The law gives the SEC the option of asking the court to impose a civil penalty equal to the amount of financial gain that resulted from the violation (15 USCA §78u (d)(3)(B)).

Barring Securities Law Violators from Acting as Officers or Directors of Public Companies

The law also authorizes the SEC to issue an order to prohibit anyone who has violated the anti-fraud provisions of the Securities act and the Exchange Act from acting as an officer or director of a publically traded company. The

prohibition may be conditional or unconditional, and may be permanent or temporary (PL 107-204, §1105). The law also gives courts this authority in proceedings the SEC initiates to enjoin violations of the securities laws (15 USCA §§ 77t and 78u).

Improper Influence on Conduct of Audits

The SEC may institute civil proceedings against officers and directors of a public company, or anyone acting at their direction, that attempts to influence any accountant performing an audit to make the company's financial statements materially misleading (PL 107-204, Section 303).

STATE CRIMINAL LAW

A corporate officer or director is criminally liable for conduct constituting an offense that he performs or causes to be performed in the name of, or on behalf of, the corporation to the same extent as if he performed it in his own name (CGS §53a-11). According to John Blowie, Senior Assistant State's Attorney of the Office of the Chief State's Attorney, prosecutors rely on several criminal laws of general applicability in connection with illegal conduct on the part of corporate officials and directors.

Blowie indicated that prosecutors often use the larceny statute against corporate officials and directors. Someone commits larceny when, with intent to deprive someone of property, or to appropriate it to himself or someone else, he wrongfully takes, obtains, or withholds it from the owner (CGS §52a-119).

The criminal code contains several specific examples of larceny, but the following three seem to be most relevant:

1. Obtaining property by false pretenses: A person, with the intent to defraud, obtains property by any false token, pretense or device.

2. Obtaining property by false promise: A person obtains property by means of a representation, expressed or implied, that he or a third person will in the future engage in particular conduct when he does not intend to engage in such conduct or does not believe that the third person intends to engage in such conduct.

3. Embezzlement: A person wrongfully appropriates to himself or to someone else property of another in his care or custody.

Generally the penalty for larceny depends on the value of the property taken. The most serious penalty is a class B felony when the value exceeds $10,000. A violator is subject to a prison term of up to 20 years, a fine of up to $20,000, or both for each offense (CGS § 53a-122).

Another general criminal statute prosecutors may rely on is making a false statement in the second degree. A person commits this offense when he intentionally makes a false written statement under oath or on a form authorized by law that he does not believe to be true and which is intended to mislead a public servant in the performance of his official function. (To be covered by this law, the form must indicate that false

statements are punishable.) A violation is a class A misdemeanor, which subjects the violator to up to one year in prison, a fine of up to $2,000, or both (CGS §53a-157b).

A third general criminal statute that prosecutors may use against corporate officers and directors is forgery. Someone commits forgery in the first degree when, with the intent to defraud, deceive, or injure someone, he falsely makes or alters a written instrument or issues or possesses any written instrument that he knows to be forged, which is or purports to be, or which is calculated to become or represent part of an issue of stock, bonds, or other instruments representing interests or claims against a corporate or other organization or its property. A violation is a class C felony, which carries a prison term of up to 10 years, a fine of up to $10,000, or both (CGS §53a-138).

Prosecutors may also use the conspiracy law. A corporate officer or director is guilty of conspiracy when, with intent that conduct constituting a crime be perpetuated, he agrees with one or more people to engage in or cause the performance of such conduct, and anyone of them commits an overt act in pursuance of the conspiracy (CGS § 53a-48). Conspiracy generally carries the same penalty as the offense the people conspired to commit except it has a maximum prison sentence of up to 20 years in prison (CGS § 53a-51).

Criminal Liability for Acts of Another

Someone who solicits, requests, commands, importunes, or intentionally aids someone to commit a crime, and has the mental state required to commit that crime, is criminally liable for the crime and may be prosecuted as if he were the principal offender (CGS § 53a-8).

CIVIL AND CRIMINAL PENALTIES FOR SECURITIES FRAUD UNDER CONNECTICUT SECURITIES LAW

Connecticut law also regulates the sale of securities under the Uniform Securities Act (CGS §§ 36b-2—36b-33). Connecticut law gives the banking commissioner authority to enforce it. In many ways it is similar to the federal law except Connecticut does not impose requirements on the initial sale of securities.

Federal Pre-emption and Retained State Authority

The National Securities Markets Investment Act of 1996 (NSMIA) pre-empts individual states from passing their own initial registration requirements for securities (P.L. 104-290). Congress passed this law to make the securities markets more efficient by reducing the number of overlapping and conflicting state and federal securities regulations. But while federal law dictates securities registration requirements and procedures, the states retain the authority to investigate and bring enforcement actions for fraud, deceit, or unlawful conduct in connection with securities transactions. Connecticut does this through the Uniform Securities Act.

Uniform Securities Act

If the banking commissioner investigates and finds that a person has violated, is violating, or is about to violate the Uniform Securities Act (USA) or its associated rules, regulations, and orders, or further sale or offers to sell securities would constitute such a violation, or that anyone has engaged in dishonest or unethical practice in securities or commodities, the commissioner can:

1. order the person to cease and desist such behavior;

2. order the person to make restitution of sums obtained in violation of the USA or its associated rules, regulations, and orders, plus interest; and

3. order the person to disgorge any sums obtained in violation of the USA or its associated rules, regulations, and orders.

The named person has up to 14 days after receiving order to request a hearing.

The commissioner can also send a notice to the person by registered mail, return receipt requested, which includes:

1. a reference to the provision alleged to have been violated,

2. a statement of matter asserted or charged,

3. the maximum fine for the violation, and

4. the time and place for the hearing (no earlier than 14 days after the notice is mailed).

Agency relationship. The commissioner can order a person who directly or indirectly controls a person liable for restitution and/or disgorgement to make restitution or provide disgorgement. The controlling person (principal) is jointly and severally liable with, and to the same extent as, the controlled person (agent). The presumption of control is rebuttable, but the burden of proof lies

with the alleged principal. The principal has up to 14 days after receiving an order to request a hearing.

Consent order. After any of these orders, the commissioner may, in his complete discretion, accept a written consent order instead of holding an adjudicative hearing. This consent order must contain:

1. an express waiver of the right to judicial review or other contest of the order's validity,

2. a provision that the order may be used in construing the terms of the consent order,

3. a statement that the consent order is final upon issuance,

4. a specific assurance that none of the violations or dishonest or unethical practices will happen again,

5. other terms and conditions necessary to further the USA's policies and purposes,

6. each respondents' signature evidencing his consent, and

7. the commissioner or his representative's signature.

Monetary Penalty. If, after a hearing, the commissioner finds the person has violated the USA or associated rules, regulations, or orders, he can also impose a fine up to $10,000 for each violation, even if the person did not attend the hearing. The commissioner must send a copy of the penalty order to the named person by registered mail, return receipt requested.

Additional remedies. The commissioner may also:

1. bring an action for an injunction, restraining order, or a court order requiring someone to do something;

2. seek a court order imposing a fine up to $10,000 per violation; or

3. apply for a court order of restitution to be paid to a receiver/conservator or to the injured party.

Criminal Penalties for Violating the Uniform Securities Act

The law imposes a fine of up to $10,000 or imprisoned for up to 10 years, or both, for anyone found to have willfully violated USA provisions prohibiting (1) directly or indirectly defrauding, misrepresenting or omitting material facts,

misleading, or perpetrating a fraud or deceit on a person in connection with (a) the offer, sale, or purchase of any security or (b) paid investment advising or (2) a person who advises or solicits advisory business on behalf of an investment advisor from engaging in dishonest or unethical behavior.

Anyone who willfully violates any other USA provision will be fined up to $2,000, imprisoned for up to two years, or both.

The statute of limitations for this provision is five years.

Buyers' Remedies

If anyone (1) offers or sells a security in violation of a registration requirement or (2) offers, sells, or materially assists in offering or selling a security by means of a material misstatement or omission, the buyer can sue. If successful, the buyer may recover (1) the consideration he paid for the security; (2) 8% annual interest from the date he paid the consideration; (3) costs; and (4) reasonable attorneys' fees, less any income he received on the security, upon tender of the security, or for damages if he no longer owns the security.

If an investment advisor engages in the following misconduct he is liable to the customer for the consideration the customer paid for his services and any loss resulting from them, less any profits the customer earned as a result of transactions based on the investment advisor's advice, plus 8% annual interest from the date the customer paid the consideration, costs, and attorneys' fees:

1. defrauding, materially misstating or omitting facts, or otherwise perpetrating a fraud or deceit on another person;

2. extending or renewing an investment advisory contract without making the required written disclosures;

3. taking unlawful custody of a client's securities or funds;

4. conducting business without being registered as an investment advisor; or

5. representing to a prospective customer that his registration or application implies that he or his transactions have the commissioner's approval.

No one who made or performed a contract in violation of USA or who acquired any right under the contract with knowledge of the facts that give rise to the violation can bring any cause of action based on the contract. Any condition, stipulation, or provision binding anyone acquiring a security or receiving investment advice to waive compliance with USA or associated regulations or orders is void.

The statute of limitations for this section, with certain exceptions, is two years.

Business Opportunity Investment Act

State law also regulates the sale of a business opportunity (CGS §§ 36b-60 — 36b-80). A business opportunity exists where someone offers to sell or lease, or actually sells or leases, products, equipment, supplies or services to enable the buyer to start his own business. The Securities and Business Investments Division of the Connecticut Department of Banking administers the Connecticut Business Opportunity Investment Act (BOIA).

Under the act, a business opportunity exists where the seller also makes one or more of the following representations to the buyer: (1) the seller will provide locations or help the buyer to find locations for the use or operation of vending machines, racks, display cases, other similar devices or currency-operated machines on premises that neither the buyer nor the seller owns or leases; (2) the seller will buy any products the buyer makes, produces, fabricates, grows, breeds or modifies using the goods or services that the seller sold him; (3) the seller conditionally or unconditionally guarantees that the buyer will derive income from the business opportunity, or represents that he will refund all or part of the price the buyer paid or buy back any of the goods he supplied to the buyer if the buyer is unsatisfied with the business opportunity; or (4) the seller will provide the buyer with a sales or marketing program.

Violations and commissioner's enforcement powers. If it appears to the commissioner that anyone is violating, or is about to violate, any provision of BOIA or its associated rules, regulations, and orders he can also send a notice to the people by certified mail, return receipt requested, which includes:

1. a reference to the provision alleged to have been violated,

2. a statement of the matter asserted or charged,

3. the maximum fine for the violation, and

4. the time and place for the hearing.

The named person has up to 14 days after receiving the order to request a hearing, and the hearing date set in the commissioner's notice can be no earlier than 14 days after notice is mailed.

Penalties and Remedies for Violations of Business Opportunity Investment Act

Monetary penalties at hearing. If the commissioner finds at the hearing that the named person violated BOIA or its associated rules, regulations, and

orders, he can impose a civil penalty of up to $10,000 per violation, regardless of whether the person appears at the hearing. The commissioner must send a copy of the penalty order to the named person by certified mail, return receipt requested.

Additional remedies. The commissioner may also:

1. bring an action for an injunction, restraining order, or an order requiring someone to take certain actions;

2. seek a court order imposing a fine up to $10,000 per violation; or

3. apply for a court order of restitution to be paid to a receiver or conservator or to the injured party.

Penalties for violations. Anyone who willfully violates BOIA provisions prohibiting directly or indirectly defrauding, misrepresenting or omitting material facts, misleading, or perpetrating a fraud or deceit on a person in connection with the sale of a business opportunity can be fined up to $25,000 for each violation, imprisoned for up to 10 years, or both. Anyone who willfully violates any other BOIA provision can be fined up to $2,000, imprisoned for up to two years, or both.

Purchaser-Investor's Remedies. Purchaser-investors injured by BOIA violations or by a seller's breach of a contract subject to BOIA can bring an action for damages, including reasonable attorneys' fees. They can also bring an action for damages against the seller's surety bond or trust account.

If anyone files a complaint that a business opportunity seller has violated BOIA, the Hartford Superior Court can enjoin the defendant from further violations.

No one who made or performed on a contract in violation of BOIA or who acquired any right under the contract with knowledge of the facts that give rise to the violation can bring any cause of action based on the contract. Any condition, stipulation, or provision binding anyone acquiring a business opportunity to waive compliance with BOIA or associated regulations or orders is void.

The statute of limitations for this section is six years.

PERSONAL LIABILITY OF DIRECTORS AND OFFICER FOR BREACHING DUTY TO CORPORATION OR SHAREHOLDERS

The law requires that corporate directors and officers carry out their duties to their corporation in certain ways or they may be personally liable to

shareholders or to the corporation itself. For example, the law requires directors to discharge their duties (1) in good faith, (2) with the care an ordinarily prudent person in a similar position would exercise under similar circumstances, and (3) in a manner they reasonably believe to be in the corporation's best interest (CGS §33-756).

Directors and officers also owe a duty of loyalty to their corporation. One aspect of this duty relates to self-dealing transactions. Another deals with taking a business opportunity of the corporation for their own benefit.

Just as in the case of violations of their duty of care, violation of their duty of loyalty may also result in lawsuits against directors or officers if their conduct injured the corporation or shareholders.

A typical way such liability is established is by a derivative lawsuit. This is a legal action filed by a shareholder on behalf of the corporation, on the theory that the corporation has been injured by the director's or officer's wrongdoing.

Derivative suits often allege that a director or office breached his duty of loyalty by a self-dealing transaction, such as a sale of corporate property at below fair-market value, or by usurping a corporate opportunity. Derivative suits may also allege that a director or officer violated his duty of due care.

A director or officer who is charged with a breach of the duty of due care, the duty of loyalty, or some other wrongdoing, can face substantial damages. For example, the defendant directors in *Smith v. Van Gorkom* (488 A 2d 858, Dec. 1985) ended up settling for $23 million even though they were not guilty of intentional wrongdoing (*Emmanuel Law Outlines*, Corporations, p. 382).

Common-Law Fraud and Deceit

Directors and officers are also subject to lawsuits based on common-law fraud and deceit. The plaintiff must show the director or officer made false representations under circumstances that entitled him to rely on them, and that as a results of the reliance he suffered damages (*Dorsey v. Mancuso* 23 Conn. App. 629 (1990)). The plaintiff must also show the representations were fraudulently made. It appears the courts may find fraud when statements are made recklessly (*Warren v. Delaney* 148 Conn. 469).

INDEMNIFICATION AND LIABILITY INSURANCE

As discussed in previous sections of this report, corporate officers and directors may be held liable under a variety of circumstances. The liability may be civil or criminal, and might be based on state or federal law. The liability may be to state or federal government in the form of a fine or penalty, or it may be in the

form of damages to shareholders, the corporation, or to third parties such as those who are injured by a corporation's actions.

The law authorizes two ways for directors and officers to be protected from liability under certain circumstances. One way is indemnification, in which the corporation reimburses the director or officer for expenses, settlements, and judgments they incur when they are sued for actions they took, or failed to take, as directors or officers.

The rules relating to indemnification are complicated as are the procedural requirements that may apply (CGS §33-700-779). Sometimes the law requires indemnification, sometimes it permits it, and other times it prohibits it (CGS §§33-771 and 33-772).

Because of the length of this report, we have not summarized the indemnification rules and procedures. Please let us know if you would like us to do so in a separate report.

Another way for a director or officer to be protected from liability is through liability insurance. The law authorizes corporations to purchase and maintain liability insurance on behalf of directors and officers against liability asserted against or incurred by them (CGS § 33-777). The law allows corporations to purchase insurance for conduct that might be beyond that which is covered by mandatory or permissive indemnification.

DEBTS NOT DISCHARGABLE IN BANKRUPTCY

The recently enacted federal law dealing with corporate fraud and other misconduct eliminated one potential shelter from liability. This act prohibits the discharge in bankruptcy of any order, fine, penalty, judgment, or settlement arising from (1) a claim that he violated any federal or state securities law or regulation, or (2) a claim of common law fraud, deceit, or manipulation in relation to the purchase of a security (PL 107-204, Section 803; 11 USCA Section 523(a)).

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