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# Private Company Executives Can Be Held Liable Under the Federal Securities Laws

An often overlooked feature of the Directors and Officers Liability landscape is that executives of privately held companies can be held liable for statements or other actions made in violation of the federal securities laws. One very recent, high-profile example of this fact involved the SEC enforcement action (and subsequent criminal proceedings) brought against the medical testing company, Theranos. There has been much discussion concerning the SEC's willingness to scrutinize Silicon Valley unicorns, but recent SEC and Department of Justice actions involving an Indiana-based company underscore the fact that all private companies, irrespective of valuation or notoriety, and their respective executives can draw the attention of federal securities regulators.

## BACKGROUND

On February 12, 2019, the SEC filed a civil enforcement action in the Southern District of Indiana against two former executives of Evansville, Indiana-based plastics manufacturer – Lucent Polymers, former CEO Kevin Kunash and former COO James Jimerson. According to the complaint, the company's business of turning waste into high-quality plastics appeared highly successful, but the company's business model was "a fraud." Allegedly, the company and its executives routinely lied to customers and falsified its certification of testing data to create the impression that its products complied with customer criteria. Kunash and Jimerson continued to promote their company, including to investors, in order to try to facilitate the sale of the company – even after an internal whistleblower brought the fraud to their attention.

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Kunash and Jimerson allegedly concealed the company's fraudulent practices and made misrepresentations in connection with the sale of Lucent to Citadel Plastics Holdings. The SEC alleged that after the sale, Kunash and Jimerson continued to conceal the fraud in order to obtain payments of the sale proceeds out of escrow and in order to help facilitate the sale of Citadel to a publicly traded company. As a result of these concealments, Kunash received payments of over $1.3 million and Jimerson received payments of over $600,000. After the sale of Citadel, the acquiring public company uncovered the fraud.

In its complaint, the SEC charges Kuhnash and Jimerson with fraud in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, and seeks permanent injunctions, disgorgement plus interest, civil monetary penalties, and officer-and-director bars.

In addition to the SEC's enforcement action, on February 12, 2019, the U.S. Department of Justice (DOJ) announced that a grand jury had issued an indictment of Kunash and Jimerson in which the two were charged with conspiracy, fraud, and money laundering. According to the DOJ's press release, "The indictment alleges that they committed fraud when they orchestrated the sale of Lucent to another company but concealed critical defects in Lucent's business, including fraud that Lucent was committing on its customers."

The DOJ's press release quotes an agency official as saying "Corporate officials who put deviousness over good faith degrade the integrity of our markets and impugn the reputation of American industry. This office will continue to prioritize the investigation and prosecution of corrupt corporate executives who enrich themselves through fraud and deception." The DOJ statement says nothing about the fact that Lucent was a private company, nor in making its statements about the agency's investigative priorities, the agency said nothing about differentiating between public and private companies.

## DISCUSSION

As the Fenwick & West law firm noted in its February 22, 2019 memo about the SEC's and the DOJ's actions, "The government's aggressive action here is a reminder that securities regulators and law enforcement agencies are increasingly scrutinizing statements made by private companies, especially statements that create investor fervor and lead to inflated share valuations."

The SEC previously made it clear in its actions against Theranos that the agency would pursue alleged securities law violations even against private companies. Of particular interest is the SEC's willingness to pursue private company executives for securities law violations who are not just high-flying, high-profile Silicon Valley firms with billion plus dollar valuations. The agency clearly is willing to go after private companies of any size and in any location if it believes the violation warrants the action.

The law firm's memo notes further that "the Lucent Polymers action in a broader sense demonstrates the SEC's continued interest in ensuring that private companies have robust internal controls and governance procedures." The law firm memo concludes by saying "Private companies should carefully analyze their procedures and controls for ensuring that their public representations and disclosures are accurate. Statements about a company's key technology are especially important to potential investors, and consequently, those statements will also be scrutinized by government regulators."

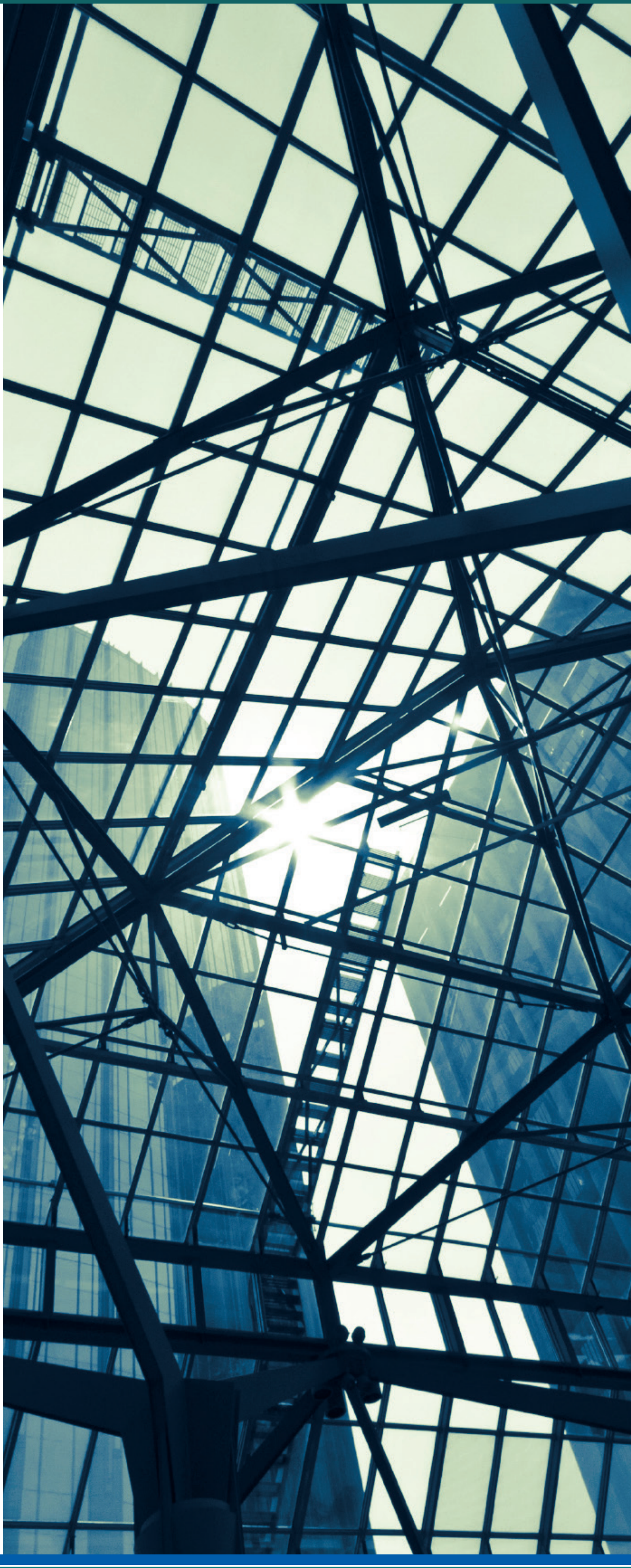
The SEC's recent actions clearly have important risk management implications for private companies. It is critically important that private companies and their executives are aware that they face potential liability exposure under the federal securities laws for alleged misrepresentations to prospective investors and others.

This exposure has potentially important D&O insurance implications. The D&O underwriting community tends to divide the world between public and private companies. As this case highlights, the division between public and private companies when it comes to liabilities under the federal securities laws is not nearly as strict as commonly assumed.

This case shows that private company executives could face SEC enforcement action; any executive caught up in these kinds of proceedings would want to look to their company's Private Management Liability insurance to provide their defense. However, whether the Private Management Liability insurance policy would respond will depend largely on the policy's actual language, including, among other things, the wording of the policy's IPO or public company securities law exclusion. The intent of this exclusion is to clarify that the Private Management Liability insurance policy will not provide coverage for public company exposures that arise after an IPO or other transaction through which a private company becomes publicly traded.

The wordings of these exclusions vary widely, and in some versions, the exclusion is written so restrictively that the insurer could seek to rely on the exclusion to preclude coverage for the above-discussed SEC and DOJ actions brought against private company executives. The best versions of these exclusions only become effective once a company's IPO is completed and do not interfere with coverage of the private company's executives for wrongful acts based upon their pre-IPO activities.

Given the increasing attention the SEC and DOJ are paying to private companies and given the variability of the D&O policies' applicable exclusionary language, it is critically important for private company executives to discuss their Private Management Liability insurance policy with their insurance advisors to ensure that the exclusionary wording is as insured-favorable as possible in this regard.



## ABOUT THE AUTHOR

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