Vicarious Liability of Controlling Persons under the Securities Acts

Dennis H. Johnston
VICARIOUS LIABILITY OF CONTROLLING PERSONS UNDER THE SECURITIES ACTS

I. INTRODUCTION

The Securities Act of 1933\(^1\) (1933 Act) and the Securities Exchange Act of 1934\(^2\) (1934 Act) regulate a broad range of activities involving the distribution and subsequent trading of securities, and impose civil liability for violation of the Acts and the various rules and regulations promulgated thereunder.\(^3\) Liability extends not only to those who are "primarily" responsible for violations, but also to those "controlling" persons who may be held vicariously liable for the acts of another under section 15\(^4\) and section 20(a)\(^5\) of the 1933 Act and 1934 Act, respectively. The liability of controlling persons is subject to defenses set forth in sections 15 and 20. Section 15 exonerates a controlling person from liability if he "had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist."\(^6\) Section 20(a) exonerates a controlling person from liability if he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."\(^7\)

In recent experience, the courts have had to grapple with the question of whether the controlling persons provisions afford the exclusive means of imputing liability to the violator's superior, or whether liability under the Acts can also be predicated upon common law principles of agency and respondeat superior. In this context, there is an inherent conflict between common law and securities law principles. The good faith defenses of the controlling persons provisions are inconsistent with the principle of absolute liability underlying rules of agency and respondeat superior. If liability may be predicated on these common law rules under the securities laws, a principal may be held accountable for the acts of his

\(^{2}\) Id. §§ 78a-78hh.
\(^{3}\) For a comprehensive discussion of civil and possible criminal liabilities under the Securities Acts, see 3 L. Loss, SECURITIES REGULATION 1682 (2d ed. 1961) [hereinafter cited as Loss].
\(^{5}\) Id. § 78t(a).
\(^{6}\) Id. § 77o.
\(^{7}\) Id. § 78t(a).
agent without regard to his good faith or lack of reasonable grounds to know of the facts constituting the violation.

The circuits that have thus far considered this issue have come to different conclusions. The Fourth and Sixth Circuits have expressly held that section 20(a) does not limit the availability of agency principles for attaching secondary liability in cases involving violations of the Securities Acts. The Second, Third, Eighth, and Ninth Circuits have adopted a contrary view by expressly holding that sections 15 and 20(a) are the exclusive methods of establishing secondary liability.

This comment will analyze the legislative intent surrounding sections 15 and 20(a) of the Securities Acts, focusing upon the common law and statutory controlling persons theories of secondary liability. In so doing, it will suggest that the better supported view is that the controlling persons provisions have excluded the application of common law theories of agency.

II. THE CONTROLLING PERSONS PROVISIONS

A. Section 15 of the 1933 Act

The 1933 Act became effective on July 7, 1933, a date roughly corresponding to the low point of the stock market, after the 1929 collapse of the securities market. The two principal objectives of the 1933 Act were to protect investors by requiring adequate and accurate disclosure regarding securities distributed to the public, and to outlaw fraud in the sale of securities whether or not newly issued.

In adopting the 1933 Act, Congress recognized that persons other than primary violators might incur liability. In an effort to deal with so-called

---


10. “The aggregate value of all stocks listed on the NYSE on September 1, 1929, was $89 billion. . . . In 1932 the aggregate figure was down to $15 billion—a loss of $74 billion in two and one-half years.” I Loss, supra note 3, at 120.

11. The purpose of the 1933 Act is stated in its title to be: “To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.” Ch. 38, 48 Stat. 74 (1933) (preamble). See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).
LIABILITY OF CONTROLLING PERSONS

"secondary participants," the controlling persons sections were added, imposing joint and several liability upon those who did not participate directly in the illegal course of conduct, but who otherwise controlled the primary violator.\footnote{12} Section 15 of the 1933 Act provides that:

Every person who, by or through stock ownership, agency or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.\footnote{13}

This section, which imposes joint and several liability upon controlling persons\footnote{14} originated in the "dummy" provisions of the original Senate draft of the Act.\footnote{15}

The "dummy" provisions appear to have been intended to prevent corporate entities from evading liability for securities law violations by the exercise of power through "dummy" directors.\footnote{16} They provided, in part, that a "dummy" was "a person who had nominal power or authority to act in any capacity but [was] under moral or legal obligation

\footnote{12}{See 77 CONG. REC. 2982 (1933); note 19 infra.}
\footnote{13}{15 U.S.C. § 77o (1970).}
\footnote{14}{Section 15 of the 1933 Act applies only where the controlled person has violated § 11 of the 1933 Act, 15 U.S.C. § 77k (1970), or § 12 of the 1933 Act, 15 U.S.C. § 77l (1970).}
\footnote{15}{The Senate draft provides:
Every person acquiring any security by reason of any false or deceptive representation made in the . . . sale . . . offer . . . or distribution of such securities shall have the right to recover any and all damages . . . from the person or persons signing, issuing, using or causing, directly or indirectly, such false or deceptive representation. S. 875, 73d Cong., 1st Sess. § 9 (1933), reprinted in 77 CONG. REC. 2981 (1933).

It should be noted that the specific proscription of the indirect use of false or deceptive representations indicates that the provision was intended to encompass the vicarious nature of a principal's liability for the acts of his agent. The draft further stated:

It shall be unlawful for any person, firm, corporation, or other entity . . . to employ any "dummy," or to act as any such "dummy," with the intent to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction . . . relating to the . . . purchase or sale of any securities which operates or would operate as a fraud upon the purchaser. The director or other person for whom any "dummy" shall act shall be held responsible under this act for any unlawful conduct by such "dummy."

S. 875, 73d Cong., 1st Sess. § 13 (1933), reprinted in 77 CONG. REC. 2982 (1933).}

\footnote{16}{Letter from Commissioner Landis to Senator Fletcher (May 2, 1934), reprinted in 78 CONG. REC. 8717 (1934), stating: "According to the Bar Association report, the proposed changes which are made in section 15 are intended to make that section applicable only to prevent the use of dummies in order to evade liability."}
to act therein in accordance with the direction of another.” 17 The relationship contemplated was one in which one party truly dominated the actions of the other and liability would arise only when the “dummy” was “resorted to with fraudulent intent.” 18

Unlike the Senate draft, the House version did not contain either a “dummy” or a “controlling person” provision, although it proposed the imposition of liability on directors for false or deceptive representations. 19 Therefore, when the House and Senate drafts were referred to the conference committee, the Senate provision relating to “dummies” became the basis for the present section 15 of the 1933 Act. 20

The original dummy provisions of the 1933 Act were criticized as being too drastic and as interfering with honest business. 21 In response, the conference committee replaced the word “director” with the words “controlling person,” deemphasized the requirement of intent to defraud by adopting the concept of control, and eliminated the word “dummy” by requiring that section 15 control be exercised over a person liable under sections 11 or 12. 22 This generalization in section 15 of the previously specific language suggests that the provision was intended to encompass a broad range of control in a variety of contexts.

17. S. 875, 73d Cong., 1st Sess. § 2(k) (1933), reprinted in 77 CONG. REC. 2979 (1933). This provision provided:

“Dummy” shall mean a person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligation to act therein in accordance with the direction of another.

18. S. REP. No. 47, 73d Cong., 1st Sess. 5-6 (1933). This provision stated in part:
The bill does not attempt to declare the use of “dummy” directors unlawful except where such use is resorted to with fraudulent intent. It requires the disclosure of the character of such directors as dummies and for whom they act. . . . The committee believes that this phase of the law will tend to do away with the present dangerous and unreliable system of depending upon dummy directors who have no responsibility.


20. Id.

21. 78 CONG. REC. 8668-69 (1934) (remarks of Senator Fletcher). It was expressed in the Senate amendment that its purpose was to “restrict the scope of the section so as more accurately to carry out its real purpose.” Id. at 8669.

22. H.R. REP. No. 152, 73d Cong., 1st Sess. 27 (1933).

Section 11 of the 1933 Act imposes liability for false or misleading statements made in the registration statement. Its provisions cover a broad range of participants including directors, underwriters, accountants, appraisers, and others signing or preparing the registration statement (other than the corporation) who can be held liable. 15 U.S.C. § 77k (1970).

Section 12 of the 1933 Act imposes liability upon a “person who offers or sells” a security. 15 U.S.C. § 77l (1970). This language is broad enough to encompass persons other than the actual vendor of the security such as an agent who “offers or sells” on behalf of his principal. The courts early progressed to the position that anyone who “participates” in the sale is liable under this section. 3 LOSS, supra note 3, at 1713-15.
LIABILITY OF CONTROLLING PERSONS

B. Section 20 of the 1934 Act

Whereas the 1933 Act is primarily concerned with the initial distribution of securities, the 1934 Act is concerned with the post-distribution process, both on the organized exchanges and in the over-the-counter markets. The 1934 Act has four basic purposes: (1) to afford a measure of disclosure to people who buy and sell securities; (2) to afford remedies for fraud in securities trading and prevent manipulation of the markets; (3) to regulate the securities market; and (4) to control the amount of the nation’s credit which goes into those markets.23

The 1934 Act contains a controlling persons provision in section 20 which is similar in effect and purpose to section 15 of the 1933 Act. Section 20(a) provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.24

Section 20(a) was consciously modeled after section 15. As Thomas C. Corcoran, one of the authors of the 1934 Act, testified before the Senate Committee on Banking and Currency: “Without reading those paragraphs [of what is now § 20], the first is taken verbatim from the Securities Act. The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section.”25

The primary difference between the control provisions of the 1933 and 1934 Acts concerns the defenses which they provide to secondary liability. The defense contained in section 20(a) exonerates a controlling person if he “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.”26 On the other hand, under section 15, the controlling person must show that he had no knowledge of, or reasonable ground to believe, that a fraud was being perpetrated.27

23. S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934); see also 1 LOSS, supra note 3, at 130-31.
27. Id. § 77o.
Although few cases have interpreted the section 15 defense, the best construction appears to be that the controlling person must exercise the "reasonable care" of a "person of ordinary prudence" in order to be exonerated from liability. This construction implies some burden of investigation into the activities of the controlled person to determine if reasonable care has been exercised in light of the facts of each particular case.

The leading case construing the section 20(a) defense is Lorenz v. Watson, where a brokerage firm was found liable for failing to adequately supervise its employees. The court held that in order to satisfy the good faith defense, "it is necessary for the defendants to show that some precautionary measures were taken to prevent the injury suffered." A contrary result "would amount to an invitation to avoid the burden and responsibility of supervising the activities of one's employees."

In summary, under section 15 of the 1933 Act (whose comparable defense clause was enacted by amendment in 1934 with the adoption of the 1934 Act) the controlling person must establish that he "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist," whereas under section 20(a) of the 1934 Act the controlling person need only establish that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." The courts have responded with differing views as to the interpretation of these provisions, and it has been suggested that the 1934 Act gives the controlling person a readier defense than that provided by the 1933 Act.

C. Who are "Controlling Persons"?

Since "control" is not defined under section 15 or 20(a), the courts

30. Id. at 732.
31. Id. at 733.
33. 3 Loss, supra note 3, at 1747.
34. "Control" is not defined, and this was deliberate according to the House Report of the Committee on Interstate and Foreign Commerce which states:
In this section and section 11, when reference is made to "control," the term is intended to include actual control as well as what has been called legally enforceable control. (See Handy & Harmon v. Burnet (1931) 284 U.S. 136). It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted.
have responded with vague and uncertain analyses of these provisions.\textsuperscript{35} In attempting to define what type or quantum of control is necessary to bring a principal within the purview of the controlling persons provisions, two discernible lines of authority have emerged.\textsuperscript{36}

In general, the definitional problem has been treated as a choice between two standards: one defines control by status and requires no affirmative conduct on the part of the controlling person to impose liability;\textsuperscript{37} the second requires a showing of control in fact over the activity, transaction, or institution through which the perpetrator acted.\textsuperscript{38}

The courts which have followed the status concept focus primarily on the legal relationship between the alleged controlling person and the perpetrator of the violation. For example, in \textit{Moerman v. Zipco, Inc.,}\textsuperscript{39} in viewing section 20(a), the court reasoned that since a corporation must be deemed to be in control of its president and since the directors are

\textsuperscript{H.R. REP. NO. 1383, 74th Cong., 2d Sess. 26 (1934).}

Although "control" is not defined under §§ 15 or 20(a) of the Securities Acts, it is defined with regard to the requirements relating to registration statements: "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise." \textit{17 C.F.R. § 240.12b-2(f) (1977).}

\textsuperscript{35. Some commentators have suggested that the control provisions were promulgated in an effort to expand the imposition of liability. It was feared that traditional theories of secondary liability would not prove adequate in extending liability to those actually responsible for violations of the securities laws. \textit{See, e.g., Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1211-12 (D. Md. 1968), aff'd on this point, 422 F.2d 1124, 1130 (4th Cir. 1970).}

Others suggest that the concept of control was left undefined to encompass a large group of potential offenders since the statutory enactment was intended to preempt other methods of imposing secondary liability. \textit{See, e.g., 78 CONG. REC. 8094-95 (1934) (remarks of Rep. Hollister).}

36. Both lines of authority appear to be compatible with the "directly or indirectly" language of the controlling persons provisions. \textit{See Note, Liability of Controlling Persons—Common Law and Statutory Theories of Secondary Liability, 24 DRAKE L. REV. 621, 630-31 (1975).}


39. 302 F. Supp. 439 (E.D.N.Y. 1969), aff'd per curiam, 422 F.2d 871 (2d Cir. 1970) (action brought by shareholders against corporation for the fraudulent conduct of corporate officer who allegedly misrepresented to plaintiff that stock offering was private with a small group of investors, whereas in fact it was public with a large group of investors).
control of the corporation, the directors would be liable for their president’s actions unless they sustained the burden of proving that they acted in good faith. 40 When the defendants contended that they could not have controlled the corporate president because there was no proof that they were elected directors in accordance with Delaware law, the court responded that “[t]he conclusion is inescapable that persons who act as directors are in control of the corporation. This is especially true in light of the liberal construction of this section as including ‘indirect means of discipline or influence short of actual direction.’” 41 Although the controlling defendants prevailed on their good faith defense, the decision indicates that a legal presumption of control over the institution involved suffices to establish indirect control over the primary violator.

In the second approach, the courts determine whether actual control is exerted, considering the facts of each case and all relevant factors evidencing an exercise of restraint, direction or command. 42 This approach is exemplified by Klapmeier v. Telecheck International, Inc., 43 an action brought to recover for alleged securities violations. In deciding whether the defendants were controlling persons within the meaning of section 15, the court noted:

The issue of “control” is a complex fact question which requires an examination of the relationships of the various alleged “controlling persons” to the person or entity which transacted the sale of securities alleged to have violated the Act, an examination of which cannot be limited to a cursory review of their proportionate equity positions, employment or director status on the relevant dates. While a majority shareholder might as a matter of law be held to “control” the entity regardless of his actual participation in management decisions and the specific transaction in question, the absence of a substantial ownership of shares does not foreclose liability under the Act as a “controlling person”. 44

While the court recognized that in certain limited circumstances “control” might arise as a matter of law, the court felt that the issue required a close analysis of the relationship between the alleged controlling person and the primary violator. 45

40. Id. at 447.
41. Id. (citation omitted).
42. See note 38 supra.
43. 315 F. Supp. 1360 (D. Minn. 1970), rev’d on other grounds, 482 F.2d 247 (8th Cir. 1973) (action brought by shareholders of merged corporation against surviving corporation and its directors, alleging misrepresentation of the fair market value of corporate assets).
44. Id. at 1361.
45. Id.
On balance, the interpretation which requires a showing of actual control more accurately reflects the legislative intent. While Congress devoted only a single paragraph to section 20(a), it noted that "[i]n this section . . . when reference is made to 'control,' it is intended to include actual control as well as what has been called legally enforceable control."\(^4\) Although this language could arguably support either view, it has been held that Congress envisioned judicial scrutiny of the facts of each particular case to see if there was sufficient control to impute secondary liability.\(^4\) Further, the purpose of the controlling persons provisions "was obviously to impose liability only on those . . . who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons."\(^4\) Imposing secondary liability based solely on status approaches the imposition of strict liability, even if the available statutory defenses are taken into consideration. While such liability seems consistent with the broad purposes of the securities laws—to protect the investing public—it is not warranted by the statutory language. Since the Securities Acts were intended to represent a dynamic balance between the policy of investor protection and the legitimate competing interests of honest business,\(^4\) the imposition of liability based solely on status would be at odds with the remedial purpose of the Acts.

III. COMMON LAW THEORIES OF SECONDARY LIABILITY

In conjunction with the secondary liability imposed by the securities laws, some courts have continued to impute liability to controlling persons through common law theories. Under traditional common law theories, once it is established that an employee's wrongful act was committed within the scope of his employment, liability is vicariously imposed upon the employer.\(^5\) In direct contrast to the controlling persons provisions of the 1933 and 1934 Acts, the employer's personal lack of culpability does not preclude the imputation of liability.\(^5\) Since the various theories of common law liability are often advanced and considered together, it is essential to clarify the scope of agency and respondeat superior principles before considering whether the controlling per-

\(^4\) H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934).
\(^4\) Id.
\(^4\) See note 112 infra and accompanying text.
\(^5\) For a discussion of the common law doctrine with specific reference to the securities law context, see 3 Loss, supra note 3, at 1431-35.
sons provisions have excluded their application for Securities Act violations.

Agency law imposes liability upon one party for the wrongful acts of another under a variety of theories. Liability arises whenever a principal either actually or apparently authorizes his agent to make a misrepresentation on his behalf. In the context of securities litigation, the use of the concepts of actual or apparent authority has led to seemingly harsh results. As long as a third party reasonably believes from the principal's conduct that a principal-agent relationship exists, the agent has "apparent authority" and the principal is liable for the agent's acts even though neither the agent nor the principal is aware of, or intends, the relationship to exist.

Since liability in this context is based on the principal's manifestation of an agent's authority to third parties, the doctrine suffers from two inherent limitations. First, it is available only to third parties who reasonably rely on the agent's authority. This limits application of the theory to persons who transfer securities in a face-to-face market transaction. Second, even where the cause of action being sued upon is based on a face-to-face transaction, the plaintiff must make a showing of due diligence. If the plaintiff was aware of, or should have been aware of, the agent's lack of authority, recovery will be denied.

52. RESTATEMENT (SECOND) OF AGENCY § 257 (1958) provides: "A principal is subject to liability for loss caused to another by the other's reliance upon a tortious representation of a servant or other agent, if the representation is: (a) authorized; (b) apparently authorized; or (c) within the power of the agent to make for the principal."

53. Id.

54. An example of this is found in SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972), where liability was imposed through agency theories of apparent authority. The defendant Nay, president and controlling shareholder of First Securities, induced fifteen of his clients to invest in a non-existent escrow fund. Each of the clients received investment advice from Nay in his personal office and knew that he was president of the defendant company. Although Nay had no actual authority to facilitate the escrow account, the court found corporate liability by expressly holding that "[a] principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud." Id. at 985.

55. RESTATEMENT (SECOND) OF AGENCY § 257 (1958), quoted at note 52 supra. The principal may escape liability under an apparent agency theory if the agent's wrongful acts are so obviously illegal that any reliance by the plaintiff on the agent's authority would be clearly unreasonable. Id., Comment a.

56. State and federal courts both require reliance on the apparent authority of an agent in derivative actions by third parties for securities law violations. See, e.g., Sennott v. Rodman & Renshaw, 474 F.2d 32 passim (7th Cir.), cert. denied, 414 U.S. 926 (1973); DeMarco v. Edens, 390 F.2d 836, 843 (2d Cir. 1968).

57. RESTATEMENT (SECOND) OF AGENCY § 8, Comment a (1958), states that "apparent authority exists only with regard to those who believe and have reason to believe that there is authority."
LIABILITY OF CONTROLLING PERSONS

Under the doctrine of respondeat superior, liability may be imputed to an innocent principal who has neither actually, impliedly, nor apparently authorized an agent’s misrepresentation, as long as the misrepresentation is made through “inherent agency power.” 58 Unlike liability based on actual or apparent authority, liability under respondeat superior is wholly independent of the principal’s conduct. 59 The rationale supporting this type of liability is derived from commercial-social policy considerations. As between an innocent principal and an innocent third party, it is felt that the principal should bear the loss since he initiated the relationship from which the agent’s tort arose. 60 Furthermore, since the principal is the one who stands to gain from the enterprise, such liability can be accounted for as a cost of doing business. “Commercial convenience requires that the principal should not escape liability where there have been deviations from the usually granted authority by persons who are essential parts of his business enterprise.” 61

Unlike the exculpatory defenses available under the controlling persons provisions, both agency and respondeat superior theories limit defenses to the lack of an express or apparent agency relationship with the principal. 62 Furthermore, the courts that have considered the issue have noted that the “lack of agency” defense is narrowly construed and must be clearly demonstrated. 63

58. “Inherent agency power” exists when representations are made by the agent during the performance of his duties and within the scope of his authority. Id. § 8A.

“Inherent agency power” is the equivalent of respondeat superior liability as applied to the master-servant relationship, and the terms are often used interchangeably. Id.

59. Id. § 161, Comment a provides that inherent agency powers are [powers held by an agent, the exercise of which are effective to subject the principal to liability in transactions in which the agent has neither authority nor apparent authority, but in which the agent derives his power wholly from his relation with the principal. They are called inherent agency powers since there is no other common designation which adequately describes them.

60. Id. § 161.

61. Id.

62. Id. § 15 provides that “[a]n agency relationship exists only if there has been a manifestation by the principal to the agent that the agent may act on his account, and consent by the agent so to act.”

63. In Sennott v. Rodman & Renshaw, 474 F.2d 32 (7th Cir.), cert. denied, 414 U.S. 926 (1973), a commodities trader brought suit alleging fraudulent securities manipulation by a son of a partner in a securities brokerage firm. Although the son, a previous associate, was not employed by the firm, he did use the firm’s phone on the trading floor. The court of appeals, after reviewing the evidence, found sufficient facts to disprove the agency relationship. The court concluded that without a showing that a partner or agent of the brokerage firm had knowledge of the fraudulent acts of such former associate, and in the absence of a showing that the former associate was purporting to act for the brokerage firm, there was no basis for holding the brokerage firm liable for the resulting damages. Id. at 39-40.
IV. STATUTORY LIABILITY AND THE COMMON LAW DOCTRINES

Although the courts which have ruled on the issue have generally allowed injured investors to recover from principals for losses they incurred as a result of the securities law violations of their agents, no single theory of recovery has been applied. The judiciary has continued to borrow from common law theories in spite of the specific provisions of the Securities Acts. The primary sources of this "borrowing" have been theories of agency, aiding and abetting, and conspiracy. The courts


65. To impose liability as an aider and abettor under § 876(b) of the Restatement of Torts, it is necessary to find three distinct elements: first, the existence of an independent wrongful act; second, knowledge by the aider and abettor of that wrongful act; and third, substantial assistance in effecting that wrongful act. RESTATEMENT OF TORTS § 876(b) (1939). Therefore, the person who is primarily liable must have violated a securities law, and the alleged aider and abettor must have known of this violation and by his conduct substantially assisted the primary violator in carrying out the unlawful scheme. Id.

Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), cert. denied, 379 U.S. 989 (1970), is an example of a securities case dealing with secondary liability in accord with the Restatement view. Brennan involved a class action by purchasers of stock of the defendant corporation who had purchased shares from Dobich Securities (a securities dealer) but had never actually received delivery of the share certificates. The action was to recover from the corporation for allegedly aiding, abetting and assisting the securities dealer in fraudulently converting the customers' money. The plaintiffs alleged that although they had notified the corporation of the unexplained delay in the delivery of their stock, the corporation failed to act, possibly because it was in the midst of a merger and leaking such information would materially affect its stock's value. Id. at 151. The lower court, while basing its finding of liability on tort principles, rejected a claim that Congress had by implication excluded aiding and abetting activities from coverage of the securities laws by stating:

In the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes. In this regard, it cannot be said that civil liabilities for damages, so well established under the Securities Exchange Act of 1934, may never under any circumstances be imposed upon persons who do no more than aid and abet a violation of Section 10(b) and Rule 10b-5.


The Seventh Circuit approved the lower court's decision by holding that a secondary defendant may be liable for giving affirmative and knowing assistance to a third party engaged in fraudulent activity which violates the securities laws. However, the court failed to discuss at what point the secondary defendant's knowledge was enough for the imposition of liability. 417 F.2d at 154-55. The court's position has been reaffirmed, in a subsequent decision where it was held that liability for aiding and abetting may be predicated on less than actual knowledge of the illegal activity. See Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969). It appears however that the amount of knowledge required will vary with the facts of each particular case. As one commentator has stated:

Some link, then, between defendants is essential unless vicarious liability is to lie for purely coincidental actions. It does not matter greatly what we call the link: agreement, understanding, combination, concert, mutual authorization, joint action or something else. The need is substantially the same whether we classify the defendants
have come to divergent conclusions: the older decisions indicated that liability under the Securities Acts did not supplant theories of common law liability; the modern trend supports the view that liability under the Securities Acts is the exclusive determinant of secondary liability.

A. Cases Imputing Liability on the Basis of Agency Principles

Probably the most lucid Securities Act decision applying agency principles rather than the controlling persons provisions is the Fourth Circuit’s decision in Johns Hopkins University v. Hutton. In Johns Hopkins suit was brought against W.E. Hutton & Co. to rescind the University’s purchase of an oil and gas production payment on the ground that a Hutton employee had falsely predicted future net revenues for the oil wells. Hutton had been employed by Trice Production Company at a two percent commission to act as a broker and agent in the sale of production payments on oil properties owned by Trice. Hutton, acting through LaPiere, the manager of Hutton’s oil and gas department, began negotiations with Johns Hopkins for the sale of one of the production payments. During the negotiations LaPiere concealed several surveys reflecting a more conservative estimate of the amount of oil in the reserves than those surveys actually presented to the University. Additionally, it was alleged that oral representations made by LaPiere inflated estimates of the amount of return that could be expected on a production payment. Johns Hopkins subsequently learned that substantially lower oil reserves and returns on its investment could be expected than those represented by LaPiere and an action was brought to rescind the transaction under section 12(2) of the 1933 Act.
Although the defendants did not urge the district court to consult the exculpatory language of section 15, it undertook sua sponte to analyze the section 15 question at length. The district court first stated that it did not "believe that Section 15, relating to 'controlling' persons, applie[d] to the employer (brokerage house)—employee relationship." Secondly, it noted that cases which had considered the application of section 15 did not "indicate in any way that Section 15, and more particularly the 'unless' provision thereof, ha[d] any application to the liability of a brokerage house for acts or omissions of its employees. Rather, Section 15 ha[d] been applied in other contexts." The court continued by stating:

The legislative history and case law, to the extent there is any, would appear to buttress a construction of Section 15 to exclude application of the latter to an employment relationship. A contrary conclusion would in effect give blessing to a hear-no-evil, see-no-evil approach by partners of a brokerage house which is hardly in keeping with the remedial purposes of the '33 Act.

Thirdly, after interpreting the legislative history, it was reasoned that Congress had not intended section 15 to be a limitation on liability; rather, the section had been designed "to establish a 'controlling person' liability which would supplement, and extend beyond, common law principles of agency and respondeat superior." Relying on the lower court's rationale, the appellate court concluded that "Hutton is liable, under familiar principles, for the tortious representations of its agents," and cited sections of the Restatement of Agency to support its conclusions.

Although the court's decision has been referred to as "the most researched opinion in this area," it leaves the applicability of section 15 uncertain. It is not clear whether the court meant that the control provisions did not apply in a broker-dealer context, or that they did not apply only to employer-employee relationships or to employer-employee relationships between a broker and its representatives. It is difficult to reconcile the fine lines the court attempted to draw between these various

---

72. The court was probably influenced by the fact that certiorari had been granted in Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir.), cert. granted, 390 U.S. 942 (1967), cert. dismissed, 393 U.S. 801 (1968).
73. 297 F. Supp. at 1211.
74. Id. at 1212.
75. Id.
76. Id.
77. 422 F.2d at 1130 (citing RESTATEMENT (SECOND) OF AGENCY §§ 257-258 (1958)).
types of relationships. The defenses of the controlling persons provisions would be of no avail where securities law liability could be based on a principal-agent relationship by means of common law theories.

In *Armstrong, Jones & Co. v. SEC*, 79 an action was brought against a brokerage firm and its chairman for violations of various sections of the 1933 and the 1934 Acts. It was alleged that the company had sold stock of the Alexander Hamilton Life Insurance Company, a Michigan corporation, for which it had claimed an intrastate exemption from registration, to nonresidents of Michigan when it knew or should have known that some of the actual purchasers of the initial offering were in fact nonresidents. Armstrong, the chairman, contended that in order to be held liable for the wrongful conduct of his employees, the court would have to find that there was a lack of adequate supervision, which is a ground for remedial action under section 15(b)(5)(E) of the 1934 Act. 80 Further, it was argued that the company could not be found to have willfully violated the fraudulent representation provisions because of the unauthorized acts of its agents. 81 The court countered by rejecting these contentions and noted that "[i]t has long been the position of the Commission that a broker-dealer may be sanctioned for the wilful violations of its agents under the doctrine of *respondeat superior.*" 82 Without offering any rationale for its decision, the court disallowed application of the exculpatory defenses of the control provisions to the finding that the acts of the agents were unauthorized, and held the company strictly liable on common law principles of agency and *respondeat superior.*

These cases and others in the Fourth and Sixth Circuits represent the only decisions which have expressly held that sections 15 and 20 do not limit the availability of agency principles for imputing secondary liability in cases involving violations of the Securities Acts. Additionally, the Fifth Circuit has adopted a similar approach sub silentio in *Lewis v. Walston & Co.* 83

**B. Cases Adopting the Exclusivity View of Sections 15 and 20(a)**

The forerunner of a series of cases in the various circuits concerning liability of an employer for Securities Act violations of its employees is

---

81. 421 F.2d at 362.
82. *Id.*
83. 487 F.2d 617 (5th Cir. 1973). In an action brought against a broker and its registered representative alleging misrepresentations, the court, without discussing § 20 liability,
Kamen & Co. v. Paul H. Aschkar & Co., a Ninth Circuit opinion considering the interplay between California agency principles and the federal securities laws. In Kamen, plaintiff Paul H. Aschkar & Co., a member firm of the New York and American Stock Exchanges, was approached by two individuals, Ross and Grossinger, with a plan calculated to increase the firm's commission business by obtaining the listed business of broker-dealers who were not members of either exchange. Kamen & Co. thereupon established a new broker-dealer division and placed Ross and Grossinger in charge with the authority to place over-the-counter orders with nonmember broker-dealers. The plan was to offer various special services, such as free long distance telephone service on listed stock quotations and orders, free access to the analyses of stock specialists, and free research material from various companies, in return for which the broker-dealers would provide Kamen & Co. with their "listed" business.

Unknown to Kamen & Co., Ross and Grossinger while in the employ of the firm had used their offices and facilities to initiate a fraudulent scheme to create a market for a quantity of worthless nonlisted stock. The modus operandi of the scheme was simple enough: nonmember broker-dealers were contacted and requested to purchase or sell listed securities through Kamen & Co. in return for which they would receive its nonlisted securities business. A second dealer would be contacted and requested to purchase the stock from the first dealer at a specified price to be sold to a third broker, and so on. By arranging a series of purchases and sales, Ross and Grossinger were able to create an artificial market and collect commissions from the transactions.

The plaintiff Paul H. Aschkar & Co., one of the dealers who fell prey to the scheme, was induced to purchase a quantity of the worthless stock at one price with the expectation of selling it to another "pre-arranged" broker-dealer at a profit. When the Ross and Grossinger scheme collapsed, Paul H. Aschkar & Co. was unable to sell the stock and upon discovering the fraudulent operation, sued to recover the purchase price of $24,875 from Kamen & Co. The plaintiff contended that both the brokerage house and its employees had violated section 12(2) of the 1933 Act by inducing the purchase of worthless securities. Further, it was concluded that Walston & Co. was liable for the acts of its representative made within the scope of her employment, citing the Restatement of Agency for support. Id. at 623.

84. 382 F.2d 689 (9th Cir.), cert. granted, 390 U.S. 942 (1967), cert. dismissed, 393 U.S. 801 (1968).

alleged that the brokerage house was liable on the basis of common law principles of agency concerning the liability of a principal for the misrepresentations of its agents.\textsuperscript{86}

The trial court found that Kamen & Co. had neither known, nor had reason to know, of its employees' fraud, and had, moreover, exercised due care in selecting and supervising its employees.\textsuperscript{87} Although Kamen & Co. was exonerated from liability as a "controlling person," the trial court predicated liability on the state law claims through agency principles.\textsuperscript{88} The Ninth Circuit Court of Appeals, applying California law, held that the finding that the brokers had ostensible authority to make the fraudulent representations was "clearly erroneous" since Kamen & Co. was "neither a participant, directly or indirectly, in the fraudulent activities of Ross and Grossinger, nor did Kamen have any reasonable ground for believing such activities were taking place."\textsuperscript{89}

In the court's view, a controlling person could be exonerated from liability on two possible grounds: (1) under the 1934 Act, if the controlling person acted in good faith and had not directly or indirectly induced the fraudulent conduct; or (2) under the comparable provision of the 1933 Act, if he had not participated either directly or indirectly in the fraudulent conduct and had not had reasonable grounds to believe that such conduct was taking place.\textsuperscript{90} The court further reasoned that "[t]he proposed guaranteed profit sales so far departed from propriety and were patently of a sufficiently unusual nature in the light of Aschkar's knowledge and experience as to put him on warning and require him to take some steps to inquire into the extent of authority of the agent."\textsuperscript{91} The court concluded by rejecting common law bases of liability as being inconsistent with the good faith defenses provided by the control provisions.\textsuperscript{92}

A subsequent Ninth Circuit decision, Zweig v. Hearst Corp.,\textsuperscript{93} reiterated the proposition that the controlling persons section of the 1934 Act affords the exclusive basis for imputing liability for Securities Act violations. In Zweig, actions were brought against a newspaper publisher to recover for alleged violations of the 1934 Act in connection with the

\textsuperscript{87} Id. at 95,137.
\textsuperscript{88} Id. at 95,139.
\textsuperscript{89} 382 F.2d at 697.
\textsuperscript{90} Id.
\textsuperscript{91} Id. at 696.
\textsuperscript{92} Id. at 697.
\textsuperscript{93} 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975).
publication of a financial column authored by a newspaper employee. The author of the article had been a reliable employee of the newspaper for approximately thirty years and was in charge of the financial column which was published daily. The article was laudatory of a publicly held corporation in which the columnist held some stock—a fact which was undisclosed. Subsequent to the publication of the column, the price of the corporation's stock sky-rocketed, at which time the financial writer disposed of some or all of his stock at this higher price. The stock soon declined sharply in price at which time action was brought against both the columnist and the publisher by a number of persons who claimed pecuniary damage as a result of the publication of the newspaper story.

The plaintiffs alleged that the author's failure to disclose his financial interest in the corporation constituted a violation of section 10(b) of the 1934 Act. Further, the plaintiffs contended that Hearst should be held vicariously liable through common law agency principles for the fraudulent acts of his employee. Relying on the rule of Kamen, the court held that no liability would attach under the doctrine of respondeat superior and that "as to Hearst, liability, if any, was as a controlling person under Section 20(a)."

One of the best reasoned decisions considering the vicarious liability of a broker for the acts of his agent is Jackson v. Bache & Co. In Jackson, plaintiff investors sought to recover against defendant brokerage firm and its registered representative for alleged violations of the 1934 Act. The plaintiffs claimed that the representative of the firm had been touting stock in a company known as Medical Logistics without having made an adequate investigation of the background and financial stability of the company. The plaintiffs contended that they invested large sums of money in the corporation which was represented as prospering, only to find that those representations were false.

In discussing the liability of the brokerage firm, the court looked to the position adopted by the court in Kamen and the intent of Congress in enacting section 20. The court noted that the legislative intent behind section 20 was essentially twofold: (1) to maximize the coverage of the Act by extending liability to even those persons having mere control; and (2) to introduce culpability or lack of good faith as an element necessary to permit recovery. Recognizing that section 20's broad concept of

94. Id. at 1131.
95. Id.
96. Id. at 1133.
98. Id. at 95.
control would always include those liable under the theory of respondeat superior, the court refused to impute liability to the brokerage firm under agency principles by noting that "if agency principles were adopted the good faith defense specifically contained in section 20 would be emasculated." The court concluded by noting that "to superimpose agency law over Section 20 would be to create a strict liability standard—a standard specifically rejected by Congress when Section 20 was adopted."100

The Jackson Court thus reasoned that: (1) the controlling persons sections impose liability upon a larger group of persons than does the law of agency;101 and (2) to compensate for the increased exposure to liability, certain defenses are available to controlling persons which are not available to persons found to be principals through agency-respondeat superior analysis.102

Also following Kamen is SEC v. Lum's, Inc.,103 an enforcement proceeding brought under rule 10b-5. The plaintiff alleged that Melvin Chasen, the chief operating officer and director of Lum's, had received a non-public, pessimistic earnings projection which was contrary to the earnings projections previously released by the company. Chasen relayed these undisclosed projections to Simon, who was a registered representative and institutional salesman for defendant Lehman Brothers, a registered broker-dealer. Simon, in turn, passed the information on to two of his institutional customers who were managers of a number of mutual funds. Acting upon this information, the customers quickly sold out their entire positions in Lum's common stock.

The Commission charged that Lehman Brothers had breached its duty to supervise its representatives by permitting Simon to maintain inside contacts with Lum's while his clients held large quantities of Lum's stock. Further, it contended that not only was Lehman Brothers liable for a failure to supervise, but was also vicariously liable through the common law principle of respondeat superior. "[A] fraud violation by an officer or employee of a broker-dealer acting within the scope of his employment," the Commission argued, "is necessarily a violation of the broker-dealer itself and the degree of fault of the broker-dealer is a factor which should be considered only in determining the sanction to be imposed."104

99. Id. (footnote omitted).
100. Id.
101. Id.
102. Id.
104. Id. at 1061-62.
The court refused to follow the Commission's position or that of *Johns Hopkins*. Although the employee was held personally liable, Lehman Brothers was exonerated from liability since the court reasoned that application of respondeat superior did "violence" to the legislative intent underlying the 1934 Act. The court focused upon *Lanza v. Drexel & Co.*, a Second Circuit decision which had approved Kamen's analysis of a broker-dealer's liability under the control provisions. Specifically rejecting the Commission's position, the court concluded that section 20(a) was the exclusive standard for determining vicarious liability. After noting that "every violation ... by a salesman does not necessarily imply a breach of the employer's duty to supervise," the court released Lehman Brothers from liability on the basis of its "good faith" defense that it neither induced the employee to commit the fraudulent acts nor was negligent in failing to supervise him adequately.

V. CONTROLLING PERSONS PROVISIONS—THE EXCLUSIVE DETERMINANT OF VICARIOUS LIABILITY UNDER THE SECURITIES ACTS

Although several courts have allowed the use of agency principles as a method of imputing vicarious liability to brokerage firms for the securities violations of their employees, the better reasoned view is that the controlling persons provisions supplant agency liability for such violations. Support for the latter position may be found in the legislative history of the Securities Acts, the statutory language of the controlling persons provisions, and a variety of cases suggesting possible policy considerations.

A. Legislative History of the Securities Acts

In proposing the passage of the 1934 Act to Congress, President Roosevelt stated that "[t]he purpose of the legislation I suggest is to protect the public with the least possible interference to honest busi-

105. *Id.* at 1062.
106. *Id.* at 1063.
107. 479 F.2d 1277 (2d Cir. 1973).
109. *Id.* at 1062-64. This view was subsequently adopted in Sanders v. Lum's, Inc., [Current Binder] FED. SEC. L. REP. (CCH) ¶ 96,020 (S.D.N.Y. 1977), where a private action was brought for damages resulting from the same occurrence involved in the injunctive proceeding instituted by the SEC.
110. 365 F. Supp. at 1064.
111. *See* notes 68-83 *supra* and accompanying text.
LIABILITY OF CONTROLLING PERSONS

Although the message seemed rhetorically clear, its interpretation led to a bitter struggle between members of the Conference Committee of the House and Senate. The ensuing debate concerned the extent of the civil liability that should be imposed upon controlling persons for securities violations. The Senate bill imposed a liability that was akin to that of "insurer's liability:"

Every person acquiring any securities specified in such statement and offered to the public shall be presumed to rely upon the representations set forth in the said statement. In case any such registration statement shall be false or deceptive in any material respect, any persons acquiring any securities to which such statement relates, either from the original [sic] issuer or from any other person, shall have the right to rescind the transaction and to obtain the return, either at law or in equity, of any and all consideration given or paid for any such securities upon the surrender thereof, either from any vendor knowing of such falsity or from the persons signing such statement, jointly or severally.\(^\text{113}\)

The Senate committee explained that the strict obligations the bill imposed represented a balance between protection of the public and possible interference with honest business, but, in reality, the bill "denied any weight to the latter interest."\(^\text{114}\) The committee stated that it had been confronted with the problem of the contrasted equities where untrue information as to material facts shall be given in any registration statement upon which the buyer presumably relies. This goes to the essence of the relief to the public. Shall the signers on behalf of the corporation be exempt from liability if it cannot be shown that they knew of the false or erroneous character of the representations made?

The question is whether ignorance of an untruth should excuse the director and leave the loss upon the buyer. To do so in our opinion would fail to give the buyer the needed relief and fail to restore confidence. If one of two presumably innocent persons must bear a loss, it is familiar legal principle that he should bear it who has the opportunity to learn the truth and has allowed untruths to be published and relied upon.\(^\text{115}\)

The House bill, on the other hand, measured liability for untrue statements in terms of "reasonable care."\(^\text{116}\) The reasonable care stan-

\(^{112}\) Letter From Franklin D. Roosevelt to Congress (March 29, 1933), S. REP. No. 47, 73d Cong., 1st Sess. 7 (1933), reprinted in 77 CONG. REC. 937 (1933).

\(^{113}\) S. 875, 73d Cong., 1st Sess. § 9 (1933), reprinted in 77 CONG. REC. 2981 (1933).

\(^{114}\) Lanza v. Drexel & Co., 479 F.2d 1277, 1295 (2d Cir. 1973).

\(^{115}\) S. REP. No. 47, 73d Cong., 1st Sess. 4-5 (1933).

\(^{116}\) H.R. REP. No. 85, 73d Cong., 1st Sess. 5, 9-10 (1933).
standard was expressed in terms of a fiduciary relationship. The bill recognized that it would be reasonable to allow a fiduciary to delegate the performance of certain acts to others, especially where professional skills or facilities not possessed by the fiduciary himself were called for. In such cases reasonable reliance by the fiduciary on the apparent skills of another would be a full discharge of his duties. The House report stated:

The demands of this bill call for the assumption of no impossible burden, nor do they involve any leap into the dark.

The responsibility imposed is no more nor less than that of a trust. It is a responsibility that no honest banker and no honest businessman should seek to avoid or fear. To impose a lesser responsibility would nullify the purposes of this legislation. To impose a greater responsibility, apart from constitutional doubts, would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public.

In choosing between these two standards of secondary liability, the Senate accepted the standards imposed by the House bill, leading to the following conclusion:

The intent of Congress in adding this Section [20], passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.

As evidenced by the debates surrounding the enactment of the 1934 Act, “insurer’s liability” was felt to be decidedly inappropriate. Not only would this call for the assumption of an “impossible burden,” but liability would be imposed irrespective of one’s personal culpability. Imposing liability by means of agency principles on controlling persons who could not have prevented the wrongful acts giving rise to such liability runs counter to the notions adopted by the House and Senate committees. The standard of secondary liability adopted presupposed some degree of fault on the part of a controlling person, and the statutory defenses simply operate as a shield against such liability where there is no culpable conduct. Furthermore, recent decisions by the Supreme

117. Id. at 5.
118. Id.
119. Id. at 5, 9-10.
121. See also Comment, Brokerage Firm’s Liability for Salesman’s Fraudulent Practices, 36 Fordham L. Rev. 95, 97 (1967).
Court suggest that the imposition of liability for non-intentional conduct is inappropriate in the context of securities litigation.\textsuperscript{122}

B. The Language of the Control Provisions

The court in \textit{Johns Hopkins} imputed liability on agency theories, reasoning that section 15 did not have "any application to the liability of a brokerage house for acts or omissions of its employees. Rather, Section 15 has been applied in other contexts."\textsuperscript{123} However, the statutory language of the controlling persons provisions,\textsuperscript{124} as amplified in other decisions,\textsuperscript{125} suggests that this line of decisions is without firm support.

First, \textit{Johns Hopkins} ignores the relatively numerous cases applying the control provisions to establish liability of broker-dealers for the acts of their employees.\textsuperscript{126} Secondly, upon careful examination, the controlling persons provisions would seem to cover the broker-employee situation since section 20(a) applies to "every person, who directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder,"\textsuperscript{127} and section 15 applies to "every person who, by or through stock ownership, agency, or otherwise . . . controls any person liable under sections 77k or 77l . . . ."\textsuperscript{128}

The use of the word "agency" in section 15 of the Act lends support to the proposition that Congress intended to supplant common law agency principles of secondary liability. Neither agency nor any other relationship is specified in section 20(a), an omission which seems to be intentional, since the drafters of the section have stated: "In this section . . . when reference is made to control, the term is intended to include actual control as well as what has been called legally enforceable control."\textsuperscript{129} Since control has been interpreted as requiring only some indirect means of discipline or influence short of actual direction,\textsuperscript{130} it would seem that

\textsuperscript{122}\textit{See, e.g.,} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

\textsuperscript{123}\textit{See notes} 73-75 \textit{supra} and accompanying text.

\textsuperscript{124}\textit{See notes} 34-38 \textit{supra} and accompanying text.

\textsuperscript{125}\textit{See notes} 84-110 \textit{supra} and accompanying text.

\textsuperscript{126}\textit{See, e.g.,} Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971); Douglass v. Glenn E. Hinton Invs., Inc., 440 F.2d 912 (9th Cir. 1971); Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968).


\textsuperscript{128} Id. § 77o.


\textsuperscript{130} \textit{See, e.g.,} Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968). The court, in discussing the congressional policy calling for a broad definition of "control," stated that "[t]he statute is remedial and is to be construed liberally. It has
the regulatory goals of the SEC could be substantially achieved without attempting to read a non-existent insurer's liability into the statute on the basis of agency theories.\textsuperscript{131}

It is ludicrous to suggest that the legislature would have gone to such extreme measures in enacting the control provisions only to have their efforts rendered nugatory by allowing strict liability to be imputed under common law principles of agency. Since section 15 specifically defines "control" with reference to the term "agency" and a House report indicates a similar construction of section 20,\textsuperscript{132} the controlling persons provisions of the Acts should squarely exclude the application of common law principles of agency in cases brought under the Federal Securities Acts.

C. Statutory Considerations Supportive of the Exclusivity Position of Sections 15 and 20(a)

The Supreme Court in \textit{Ernst & Ernst v. Hochfelder}\textsuperscript{133} has recently adopted the view that the imposition of liability for non-intentional conduct is inappropriate under the Securities Acts. In \textit{Hochfelder}, the degree of culpability required for the imposition of liability under rule 10b-5 was considered. Customers of a brokerage firm who had invested in a fraudulent investment scheme brought an action against the accounting firm responsible for auditing the brokerage firm's books. The plaintiffs alleged that the fraudulent act of the brokerage firm's president had been in violation of rule 10b-5 and that the accounting firm had aided and abetted in the violation by failing to conduct proper audits, thereby preventing discovery of the fraudulent scheme.\textsuperscript{134}

In deciding whether negligence was a proper standard for imputing secondary liability through a private cause of action, the Court looked to the legislative intent surrounding the 1934 Act. Although rule 10b-5 was intended as a catch-all provision enabling the Securities and Exchange Commission to deal with "new manipulative or cunning devices,"\textsuperscript{135} it was noted that "[n]either the legislative history nor the briefs supporting respondents identify any usage or authority for construing 'manipulative

\textsuperscript{131} See notes 113-20 supra and accompanying text (the Senate's "insurer's liability" provision was expressly rejected by Congress when the 1934 Act was enacted).

\textsuperscript{132} H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934).

\textsuperscript{133} 425 U.S. 185 (1976).

\textsuperscript{134} Id. at 189-90.

\textsuperscript{135} Id. at 203.
Commenting on the express civil liabilities provided, the Court stated: "There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provision of § 10(b) should be interpreted no more broadly." After reviewing the administrative history of various sections of the 1934 Act, the Court held that rule 10b-5 was intended to apply only to activities that involved some form of scienter or a state of mind embracing intent to deceive, manipulate, or defraud. Hochfelder signals the Court’s receptiveness to the proposition that the defenses contained in the controlling persons provisions should be available to defendants in securities actions. Further, there is no reason to believe that Congress intended the imputation of vicarious liability absent the element of personal culpability. Liability cannot be imposed in disregard of the delicate policy balance between investor protection and honest business which underlies the federal securities enactments.

Due to the enormity of potential damages recoverable for securities law violations, imposing liability regardless of personal culpability places an undue burden on honest business in opposition to the congressional intent surrounding the enactments. In Hochfelder, the Court reversed its expansive trend and adopted a more restrictive interpretation in 10b-5 actions. Since negligence alone is not a sufficient showing of culpability, the case represents a shift away from a strict liability standard, opposing the type of absolute liability that would be imposed by common law agency principles. To paraphrase Judge Friendly’s famous assertion, the consequences of a contrary conclusion are frightening.

---

136. Id. (footnote omitted).
137. Id. at 206.
138. Id. (quoting SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969)).
139. Id. at 193.
140. Id. at 206.
141. See note 112 supra and accompanying text.
Further support for the exclusivity of sections 15 and 20(a) can be drawn from maxims of statutory interpretation adopted in actions brought under other sections of the Securities Acts. An example of this can be found in the case of Blau v. Lehman,\(^ {144}\) an action under section 16(b)\(^ {145}\) to recover short-swing profits realized as a result of trading on the basis of inside information. In Blau, the United States Supreme Court held that the mere fact that a partner in Lehman Brothers was a director of the corporation from which the profits were realized was insufficient to render the partnership liable, absent a finding that the particular partner-director had suggested the purchase or was deputized to represent Lehman Brothers on the board of directors.\(^ {146}\) The Court stated that "[l]iability under Section 16(b) is to be determined neither by general partnership law nor by adding to the 'prophylactic' effect Congress itself clearly prescribed in Section 16(b)."\(^ {147}\) The Court reasoned that since section 16(b) was a restrictive statute with clear limits defining Securities Act liability, it was intended to be exclusive in its designation of those against whom an action may be maintained.\(^ {148}\)

An analogous argument regarding the exclusivity of sections 15 and 20(a) can be asserted. A basic premise underlying the argument is that specific statutory provisions should be utilized whenever applicable instead of a more general remedy.\(^ {149}\) Note also that since the securities legislation is broad and inclusive, a plaintiff should not be able to bring an action under federal antifraud provisions and at the same time attempt to hold a defendant absolutely liable under common law agency principles in derogation of the specific defenses provided as part of the same statutory scheme. Liability should only extend to those controlling persons who were in some meaningful sense culpable participants.\(^ {150}\)

\(^{144}\) 368 U.S. 403 (1962).


\(^{146}\) 368 U.S. at 409.

\(^{147}\) Id. at 414.

\(^{148}\) Id. at 412.

\(^{149}\) Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970). Where it was clear that plaintiff had a cause of action under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2) (1970) while bringing a 10b-5 action, the court based the plaintiff's recovery on § 12(2) declaring: [A] private action under Rule 10b-5 originated in the need for a sellers remedy where none had otherwise been provided. Once a remedy was implied for the seller, it was extended to include the buyer even though relief was already available to him under Section 12(2). Since in this case recovery is sought under both provisions, we resolve any conflict between them in favor of Section 12(2), where the statutory remedy is explicit.

429 F.2d at 355 (footnotes omitted).

\(^{150}\) See notes 121-22 supra and accompanying text.
The Blau approach has also been applied in the area of 10b-5 litigation in *Blue Chip Stamps v. Manor Drug Stores*. In *Blue Chip*, as a result of an antitrust consent decree, Blue Chip Stamps was required to prepare a prospectus to offer a number of its shares of common stock to retailers who had used the stamp service in the past but who were not previously shareholders in the company. The plaintiffs brought a 10b-5 action claiming they were dissuaded from purchasing the new stock because the prospectus was materially misleading in its overly pessimistic appraisal of Blue Chip's status and future prospects. The Supreme Court denied standing to these plaintiffs noting that although in the past it had encouraged flexible construction of the Acts, "[n]o language in either [section 10(b) or rule 10b-5] speaks at all to the contours of a private cause of action for their violation." The Court continued, "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly [in section 16(b) of the 1934 Act]."

Thus, specific statutory provisions should be employed when possible rather than the more general remedies adopted as a matter of policy and, by analogy, the specific controlling persons provisions of the Securities Acts should be utilized rather than the more general remedies under common law agency principles.

**D. Policy Considerations Supportive of the Exclusivity Position of Sections 15 and 20(a)**

Agency principles which impose liability upon an innocent principal do so simply because such a distribution of loss is commercially and socially reasonable. A multitude of ingenious reasons have been offered to support imputing liability to a principal: he had more or less "control" over the behavior of the agent; he had "set the whole thing in motion" so he should therefore be responsible for what happens; or more frankly and cynically, "[i]n hard fact, the real reason for the employers' liability is [that] the . . . damages are taken from a deep pocket."
Secondary liability, according to the modern justification, is a rule of policy, a deliberate allocation of the risk. The losses caused by the acts of an employee, which as a practical matter are sure to occur in the conduct of the employer's business, have been allocated as a required cost of doing business. It is reasoned that businesses can better absorb the costs by distributing them through prices, rates, or liability insurance.

At first glance, it appears justifiable to allocate liability to an employer where an innocent third party would otherwise be forced to assume the loss. However, it seems less reasonable to hold a broker vicariously subject to liability for his employees’ violations when the broker has done everything in its power to prevent the wrongful conduct. In the area of securities litigation, a principal may be faced with enormous potential liability predicated upon the wrongful acts of its agents. Under common law principles, liability may be imputed to an innocent principal who has neither actually, impliedly, nor apparently authorized an agent’s misrepresentation. While it may be proper to allocate liability as a cost of doing business in certain contexts, in Securities Acts proceedings, whether they be administrative or judicial, there is no compelling reason to allocate liability between two “innocent” parties.

Not only is there no need to impute liability under common law theories of respondeat superior to a non-culpable principal for the unauthorized wrongful conduct of his agents, such imputation runs counter to the statutory scheme. In 1964, the 1934 Act was amended and new statutory causes of action were added. The amendments created a new ground for disciplining a principal—for failure “reasonably to supervise, with a view to preventing violations,”—and added a further provision that no person shall be deemed to have failed reasonably to supervise if there existed an established and reasonably observed system of procedures which could be expected to prevent and detect such violations of other persons.

159. Id. This justification has been referred to as the real reason for employer’s liability.

160. Judge Friendly, commenting on the potential for damages under rule 10b-5, has referred to the possibility that unduly expansive imposition of civil liability “will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.” SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (Friendly, J., concurring).

161. See note 58 supra and accompanying text.


163. Section 15(b)(5)(E) of the 1934 Act provides in part:
For the purposes of this clause (E) no person shall be deemed to have failed reasonably to supervise any person, if—
(i) there have been established procedures and a system for applying such proce-
Application of respondeat superior in this context would not only be inconsistent with the amendments but would nullify the congressional intent to make failure to supervise a separate statutory cause of action.\textsuperscript{164} Arguably, the new statutory causes of action shifting the burden of proof\textsuperscript{165} from that which existed at common law impose unreasonable responsibilities upon those held strictly liable for their employees' acts. To compensate employers for the increased likelihood of recovery for employee wrongful conduct, they should be allowed to rely upon the good faith defenses of the controlling persons provisions of the Securities Acts. If principals are not allowed these statutory defenses, they will be held vicariously liable for their employees' acts even though they have maintained an adequate system of supervision. If agency principles could viably be used to impute liability, sanctions would be imposed for failure to supervise without yielding correlative protection to those who adequately supervise. This would have the effect of disturbing the delicate balance between the interests of investors and honest business.

This same sort of inequity would also flow from section 15(b)(5)(E) of the 1934 Act which makes brokers liable for the unlawful conduct of their associates.\textsuperscript{166} Although the section seems to create the statutory equivalent of strict liability, this result can be avoided by reading into it the good faith defenses provided by the controlling persons provisions. Viewed in light of the administrative history of the 1964 amendments, this seems to be what Congress intended. The committee reports provide that "it has never been the practice . . . nor would it be consistent with our traditions, to punish innocent people for the conduct of another for which they had no responsibility and of which they had no knowledge."\textsuperscript{167} Such a policy would seemingly exonerate a broker from

\begin{itemize}
\item\textsuperscript{164} See 5 Loss, supra note 3, at 3375-76 (Supp. 1969).
\item\textsuperscript{165} This shift of burden relieves the purchaser from common law obligations and puts the burden on the seller. As noted in Stern v. American Bankshares Corp., [Current Binder] \textit{Fed. Sec. L. Rep. (CCH)} \textsuperscript{\textregistered} 96,033, at 91,631 (E.D. Wis. 1977), "once it is established that a defendant is a controlling person, the burden shifts to the defendant to show that he acted in good faith and did not directly or indirectly induce the fraudulent transaction."
\item\textsuperscript{166} The phrase "associated with a broker-dealer" was defined by the 1964 amendment to mean: "any partner, officer, director, or branch manager of such broker or dealer . . . or any person directly or indirectly controlling or controlled by such broker or dealer, including any employee of such broker or dealer . . . ."
\end{itemize}
liability for his associates' violations where an adequate supervisory system was employed, and further reinforces the argument that the control provisions provide the exclusive means for imputing vicarious liability.

Another argument supporting the exclusivity position of sections 15 and 20(a) relates to a compromise between the public interest and the obligation to supervise thoroughly. The 1933 and the 1934 Acts have been recognized as a compromise between the interests of the investing public and those of the business community. It has been suggested that the controlling persons provisions were enacted to extend liability to those agency situations where strict application of agency principles would preclude liability—a position which fails to perceive or deal adequately with the extensive obligations which would be imposed upon controlling persons. A separate cause of action was adopted for failure to supervise, reflecting a congressional design to promote more rigorous supervisory standards and arguably suggesting that, with respect to the "public interest," a controlling person's prime obligation is to supervise. Accordingly, the "control" duties should be limited to careful hiring practices and adequate supervisory procedures which are directed toward the detection of employee fraud.

The proponents of "agency principles" who argue that the imposition of strict liability in the securities field will have a deterrent effect on fraudulent conduct fail to perceive the existing stringent rules to which brokerage firms are already subjected, including the rules of the SEC, the various exchanges, and the National Association of Securities Dealers (NASD). Such firms, required by regulation to hire carefully and supervise thoroughly, are already forced to do everything in their power to prevent securities law violations by their employees. With regard to this group of litigants, it seems highly unlikely that the imposition of strict liability will serve any purpose in deterring fraudulent conduct. Furthermore, if the ostensible agency-respondeat superior principles were utilized in conjunction with the controlling persons provi-

168. See note 112 supra and accompanying text.
171. See NATIONAL ASS'N SEC. DEALERS MANUAL (CCH 1971); see, e.g., New York Stock Exchange Rule 345.
172. See NATIONAL ASS'N SEC. DEALERS MANUAL (CCH 1971).
173. See, e.g., New York Stock Exchange Rule 345.
sions, the controlling persons provisions would be useless due to the emasculation of the good faith defense.

Rather than impeding the efforts of Congress by imposing liability without fault, if the courts simply interpreted the good faith defense to require high supervisory standards, strict liability could virtually be imposed where the courts deemed its imposition necessary. If this approach were adopted, the courts could continue balancing the interests of the public and honest business as envisioned by the Securities Acts.

VI. CONCLUSION

For the past forty years, the courts have been confronted with a multitude of problems in attempting to reconcile inconsistent theories of securities regulation. Although the judiciary has repeatedly faced the question of whether the controlling persons provisions afford the exclusive means of imputing vicarious liability, or whether liability may also be predicated upon common law principles of agency, the question is unresolved, as a distinct split has emerged in those circuits which have confronted the issue. As evidenced by the Hochfelder decision, liability predicated upon mere negligence is decidedly inappropriate, which suggests that the Supreme Court is shifting the delicate balance between investor protection and business interests away from standards of strict liability. The language of the controlling persons provisions, as well as the legislative intent surrounding the securities enactments, compels the conclusion that the Securities Acts have supplanted vicarious liability under the traditional common law agency theories.

Dennis H. Johnston