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# Controlling Securities Fraud: Proposed Liability Standards for Controlling Persons under the 1933 and 1934 Securities Act

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# "Controlling" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts

## INTRODUCTION

Despite congressional enactment of the Securities Act of 1933<sup>1</sup> (1933 Act) and the Securities and Exchange Act of 1934<sup>2</sup> (1934 Act), fraudulent activities continue to plague the securities markets.<sup>3</sup> Adopted to deter fraud and restore confidence in the securities markets,<sup>4</sup> the Acts impose broad accountability standards for fraudulent conduct. Congress created direct liability for individuals who commit securities fraud,<sup>5</sup> and as an additional deterrent, section 15 of the 1933 Act and section

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1. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982 & Supp. IV 1986)). The 1933 Act was enacted primarily to regulate the initial distribution of securities, to deter fraud, and to make all information pertaining to the purchase of the offered securities available to the investor. 1 L. LOSS, *SECURITIES REGULATION* 130 (2d ed. 1961).

2. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982 & Supp. IV 1986)). The 1934 Act was adopted to regulate the securities markets, to provide a disclosure method to the people buying and selling securities, to create remedies for fraud, and to control the amount of the nation's credit being put into the securities market. 1 L. LOSS, *supra* note 1, at 130-31.

3. See *Memorandum of the SEC in Support of the Insider Trading Sanctions Act of 1982*, Fed. Sec. L. Rep. (CCH) No. 1039, Special 1, pt. II, at 21 (Sept. 28, 1983) (despite vigorous enforcement efforts securities violations continue to occur because of the opportunity to reap huge profits with small risks); see also Burrough, *Fates Are Disparate for Those Charged With Insider Trading*, Wall St. J., Nov. 18, 1987, at 1, col. 6 (reviewing recent convictions of prominent individuals in the securities industry for insider trading).

4. 77 CONG. REC. 2914 (1933) (remarks of Rep. Greenwood), *reprinted in* 1 J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934*, Item 7 (1973) [hereinafter *LEGISLATIVE HISTORY*]. After the 1929 stock market crash, Congress believed the "necessity for . . . legislation to help restore confidence in our local banking institutions [was] great." *Id.* In a special message to Congress, President Franklin D. Roosevelt also called attention to the fragile state of financial institutions, stressing the need to deter securities fraud. See 77 CONG. REC. 937 (1933) (message from President Franklin D. Roosevelt to the Senate regarding regulation of security issues), *reprinted in* 1 *LEGISLATIVE HISTORY*, Item 3.

5. Under the 1933 Act, for example, if any part of a registration statement is untrue or omits a material fact, an investor may sue every person who signed the registration statement; was a director of, or partner in, the issuer at the time of the filing; is named on the statement; took any part in the prepara-

20(a) of the 1934 Act<sup>6</sup> establish secondary liability for persons who exercise "control" over primary violators of the securities regulations.<sup>7</sup>

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tion or certification of the document (as an accountant, engineer or appraiser); or performed underwriter duties. 15 U.S.C. § 77k(a)(1)-(5) (1982).

If a securities violation does occur, the investor may recover for any loss, including the price at which the security was offered to the public, other damages incurred, and attorney's fees. 15 U.S.C. §§ 77k-77l (1982). Moreover, any person found to violate the 1933 Act is subject to a \$10,000 fine and a five-year prison term. 15 U.S.C. § 77x (1982). Willful violations of the 1934 Act may result in a \$10,000 fine and a two-year prison term. 15 U.S.C. § 78ff (1982 & Supp. IV 1986).

6. Section 15 of the 1933 Act provides:

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 sections 77k or 77l of this title, 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.

15 U.S.C. § 77o (1982).

Section 20(a) of the 1934 Act 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.

15 U.S.C. § 78t(a) (1982).

Although similar on their faces, the statutes differ significantly. An action may be brought under § 15 *only* for violations of §§ 11 and 12 of the 1933 Act. 15 U.S.C. § 77o (1982). Section 11 addresses civil liability for the distribution of false or misleading registration statements. 15 U.S.C. § 77k (1982). Section 12 provides civil liability for violations of § 5, requiring securities to be registered before transporting them for sale, and the distribution of false proxy statements. 15 U.S.C. §§ 77e-77l (1982). Under § 20(a), however, a controlling person may be held liable for violating *any* section of the 1934 Act. 15 U.S.C. § 78t(a) (1982). Because of its broader application, § 20(a) of the 1934 Act is used more frequently.

7. 15 U.S.C. §§ 77o, 78t(a) (1982). *But see* *Stoller v. Baldwin-United Corp.*, 41 Bankr. 884, 890 (S.D. Ohio 1984) (liability under controlling person provisions is "neither remote nor secondary").

Although Congress did not define a controlling person, the courts generally consider any person who has control or influence over another to be in a controlling position. *See, e.g.*, *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981). For examples of controlling persons, see *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981) (accounting firms), *cert. denied*, 455 U.S. 938 (1982); *Marbury Management v. Kohn*, 629 F.2d 705, 716 (2d Cir.) (brokerage firms), *cert. denied*, 449 U.S. 1011 (1980); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132-33 (9th Cir.) (newspaper publisher), *cert. denied*, 423 U.S. 1025

When it adopted the secondary liability provisions of the 1933 and 1934 Acts, Congress intentionally failed to define *controlling person*.<sup>8</sup> Congress believed that it could not predict every potential way of influencing or controlling a person and thus decided to allow the courts to draw the appropriate boundaries in particular cases.<sup>9</sup> Without congressional guidance,<sup>10</sup> however, courts have failed to develop a uniform standard for imposing secondary liability on controlling persons.<sup>11</sup> Some courts interpret the controlling person provisions as requiring proof that the controlling person, in some meaningful manner, intentionally participated<sup>12</sup> in the controlled person's fraudu-

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(1975); *Mader v. Armel*, 461 F.2d 1123, 1125-26 (6th Cir.) (directors), *cert. denied*, 409 U.S. 1023 (1972); *Kammerer v. Weaver*, 445 F.2d 76, 79 (7th Cir. 1971) (corporate sales managers); *Whittaker v. Wall*, 226 F.2d 868, 871-72 (8th Cir. 1955) (officer and stockholder); *Draney v. Wilson, Morton, Assaf & McElligott*, 597 F. Supp. 528, 531 (D. Ariz. 1983) (municipality). *But see Fuls v. Shastina Properties*, 448 F. Supp. 983, 989-90 (N.D. Cal. 1978) (lenders cannot be controlling persons); *Carr v. New York Stock Exch.*, 414 F. Supp. 1292, 1303 (N.D. Cal. 1976) (mem.) (national securities exchange cannot be controlling person).

8. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934) (in declining to define controlling persons, Congress noted that it is "difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted"), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 4, Item 18; *see* 15 U.S.C. §§ 77a-77aa, 78a-78kk (1982 & Supp. IV 1986) (no definition provided).

9. While arguing against defining a controlling person, Representative Lea asserted that the determination of who is a controlling person is a "question of fact to be determined by the issues presented in the case." 78 CONG. REC. 8095 (1934), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8.

10. Although almost all lower courts interpreting §§ 15 and 20(a) of the securities acts agree that Congress did not provide a standard on which to base a controlling person's liability, the United States Supreme Court seems to differ. Without elaborating, the Supreme Court has noted that, "[i]n each instance that Congress created express civil liability . . . it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207 (1976) (citing §§ 15 and 20(a) of the securities acts).

11. *SEC v. Savoy Indus.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978) (history of interpretations of controlling person provisions has "hardly been a history of consistency"), *cert. denied*, 440 U.S. 913 (1979); *see* Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities and Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1021-22 (1973) (most courts determine controlling person's liability with "vague labels and uncertain analysis[, and only] a few courts have carefully delineated the determinative elements of 'control'"); *see also* Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1010 (1983) (only better reasoned cases separate issue of control from issue of whether defendant's conduct satisfies statutory defenses); *infra* notes 60-89 and accompanying text.

12. Courts asserting that a controlling person cannot be held liable unless the complainant proves the controlling person intentionally participated in the fraud call the standard "culpable participation." *See, e.g., Orloff v. Allman*, 819

lent conduct.<sup>13</sup> Other courts reject this position, asserting that liability does not depend on whether the controlling person actually participated in the fraud,<sup>14</sup> but only on whether the controlling person could have discovered or deterred the fraudulent activity.<sup>15</sup> Once courts decide on a standard for secondary liability, they apply that same standard under the controlling person provisions of both the 1933 and the 1934 Acts.<sup>16</sup>

This Note contends that application of an identical standard to actions brought under either securities act has caused courts difficulty in developing a secondary liability standard for controlling persons. The Note suggests that although Congress adopted both Acts to accomplish essentially the same goals, the statutes employ substantially different means to achieve those goals.<sup>17</sup> Part I introduces the securities acts and reviews the legislative history of sections 15 and 20(a), the controlling person provisions. Part II discusses conflicting judicial interpretations of those provisions. Part III analyzes why current standards inadequately reflect Congress's intent and proposes that courts should adopt a different standard to determine controlling person liability under each Act. The Note concludes that courts should construe the controlling person provision to require a negligence standard under the 1933 Act and a reck-

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F.2d 904, 906 (9th Cir. 1987); *Rochez Bros. v. Rhoades*, 527 F.2d 880, 885 (3d Cir. 1975). This is a misnomer, however, because culpable participation does not necessarily require a controlling person to consciously intend to participate in the fraud. See BLACK'S LAW DICTIONARY 341 (5th ed. 1979) (defining culpability as blameworthiness that requires "knowing, reckless, or negligent conduct") (emphasis added). Courts requiring culpable participation in effect require intentional participation. See, e.g., *Rochez Bros.*, 527 F.2d at 890 (it must be apparent that the controlling person intentionally furthered the fraud). Thus, for clarity, this Note uses the term intentional participation to refer to what some courts call culpable participation in securities fraud.

13. See *infra* notes 60-73 and accompanying text.

14. See *infra* notes 74-89 and accompanying text.

15. See *infra* notes 74-89 and accompanying text.

16. See, e.g., *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981) (§§ 15 and 20(a) should be given same interpretation).

17. Congress enacted the 1933 Act to regulate the initial distribution of securities and to promote full and fair disclosure of securities information. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1973); see also H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933) (literature regarding new issues must fully disclose character of securities to afford investors accurate judgments), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18. Congress enacted the 1934 Act to regulate transactions on the securities exchanges and over-the-counter markets. See *Blue Chip Stamps*, 421 U.S. at 740; see also S. REP. NO. 792, 73d Cong., 1st Sess. 1-5 (1934) (investigation of buying and selling practices demonstrates need to regulate trading), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 4, Item 17.

lessness standard under the 1934 Act. Differentiating the standards for secondary liability under the Acts promotes the general legislative goals while reflecting the different regulatory functions of each Act.

I. THE CONTROLLING PERSON PROVISIONS OF THE  
1933 AND 1934 SECURITIES ACTS: SECTIONS 15  
AND 20(a)

Although Congress adopted both the 1933 and 1934 Acts in response to the October 1929 stock market crash<sup>18</sup> for the same general purposes—to deter fraud and encourage investor confidence in the securities markets<sup>19</sup>—the Acts regulate very different activities. The 1933 Act primarily regulates initial stock offerings and the distribution of information concerning their character.<sup>20</sup> It requires persons seeking to issue and sell securities publicly to disclose information necessary for informed investment decisions both to the Securities Exchange Commission (SEC) and to potential securities purchasers.<sup>21</sup> In contrast to regulating the offering and sale of securities, the 1934 Act regulates the markets in which they are traded.<sup>22</sup> In general, it requires the stock issuers and exchanges to register with the SEC and abide by certain trading prohibitions.<sup>23</sup>

Both the 1933 and 1934 Acts allow investors to recover losses, subject to varying procedural restrictions, from persons who violate the Acts.<sup>24</sup> In addition to primary liability, both

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18. 77 CONG. REC. 2939-40 (1934) (remarks of Rep. Koppleman), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 7.

19. *See supra* notes 1-7 and accompanying text.

20. 1 L. LOSS, *supra* note 1, at 130. *But see infra* note 149.

21. *Responsibility of Corporate Officers & Directors Under Federal Securities Laws*, Fed. Sec. L. Rep. (CCH) No. 1178, pt. II, § 202, at 23 (2d ed. May 21, 1986).

22. 1 L. LOSS, *supra* note 1, at 130-31; *see* S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934) (1934 Act intended to regulate securities exchanges and to prevent fraudulent transactions), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 4, Item 18.

23. 1 L. LOSS, *supra* note 1, at 131. Registrants must keep information filed with the SEC current by filing annual and other reports. *Id.* The SEC may inspect this information at any time and may deny or revoke registration. *Id.* Additionally, there are provisions governing securities trading by the issuers' officers, directors, and principal shareholders. *See, e.g.*, 15 U.S.C. § 78p(b) (1982) (directors and officers may not sell and purchase or purchase and sell within six-month period).

24. For the procedural restrictions applicable to suits brought under the 1933 Act, *see infra* text accompanying notes 156-60. For those requirements under the 1934 Act, *see infra* text accompanying notes 173-78.

the 1933 and 1934 Acts permit an investor to recover from those persons who are deemed secondarily liable. Section 15 of the 1933 Act and section 20(a) of the 1934 Act establish liability similar in nature to the common law doctrine of respondeat superior.<sup>25</sup> Section 15 imposes secondary liability on persons who "through stock ownership, agency, or otherwise" control another person who is liable under the Act.<sup>26</sup> Similarly, section 20(a) provides that a person who "directly or indirectly, controls any person" liable under the Act shall also be liable.<sup>27</sup> Those provisions hold the controlling person jointly and severally liable for the controlled person's fraudulent activities.<sup>28</sup>

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25. Respondeat superior is the common law principle that holds an employer responsible for the tortious acts of employees and agents even though the employer may be without fault. RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958); see Note, *Rule 10b-5—the Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383 (1982) (discussion of relationship between controlling person provisions and common law principles).

Despite Congress's explicit statement that the remedies provided by the securities acts only add to "all other rights and remedies that may exist at law," 15 U.S.C. §§ 77p, 78bb(a) (1982), the circuits disagree as to whether the controlling person provisions preclude the imposition of secondary liability on the basis of agency principles such as respondeat superior. The Second, Fourth, Sixth, and Seventh Circuits hold that the controlling person provisions are not exclusive sources of secondary liability under the securities acts; the Third and Ninth Circuits reach the opposite conclusion. Compare *Marbury Management v. Kohn*, 629 F.2d 705, 716 (2d Cir.) (securities laws do not preclude use of agency principles), *cert. denied*, 449 U.S. 1011 (1980); *Holloway v. Howerdd*, 536 F.2d 690, 694 (6th Cir. 1976) (plaintiff permitted to proceed under doctrine of respondeat superior); *Fey v. Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974) (securities laws have not preempted common law); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970) (permitting use of agency principles), *cert. denied*, 416 U.S. 916 (1974) with *Rochez Bros. v. Rhoades*, 527 F.2d 880, 884 (3d Cir. 1975) (use of agency principles prohibited); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132-33 (9th Cir.) (violation of securities acts must be based on controlling person provision, not agency doctrines), *cert. denied*, 423 U.S. 1025 (1975).

According to some courts, using agency doctrines against controlling persons circumvents the purpose behind the adoption of the securities acts because the common law doctrine provides no affirmative defenses while the securities acts do. *Rochez Bros.*, 527 F.2d at 885-86. Other courts advocate the use of agency principles because if courts impose liability only when the controlling person was intentionally involved in the fraud, many people could escape liability merely by showing that they did not actually take part in the fraud committed by the agent. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1980) (criticizing *Rochez Bros.*).

26. See *supra* note 6.

27. See *supra* note 6.

28. See *supra* note 6. Joint and several liability is applied when two or more persons' wrongful acts cause injury to a third person and it is impossible to determine in what proportion each act contributed to the injury. 74 AM.

Both provisions also provide controlling persons with affirmative defenses.<sup>29</sup>

Although the initial draft of the 1933 Act did not contain a provision similar to section 15, the current controlling person provision,<sup>30</sup> Congress eventually amended the bill by incorporating "dummy" provisions.<sup>31</sup> Those provisions defined

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JUR. 2D *Torts* § 62 (1979). All wrongdoers are responsible for the entire injury even if their wrongful acts alone might not have caused the injury or the injury would have occurred from other wrongful acts alone. *Id.*

29. Section 15 of the 1933 Act holds a controlling person liable unless "the controlling person had no knowledge of or reasonable ground to believe in the existence of the [fraud]." 15 U.S.C. § 77o (1982). Section 20(a) of the 1934 Act holds a controlling person liable unless "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation." 15 U.S.C. § 78t(a) (1982). Congress did not indicate in the legislative history why it chose to use different wording in each statute when providing for the defenses. Although the defenses under §§ 15 and 20(a) differ substantively and literally, *see generally* Note, *The "Controlling Persons" Liability of Broker-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L.J. 824 (arguing the provisions are substantively unique), most courts assert that the sentence structure of the two statutes is very similar and the provisions must be identically construed. *See, e.g.,* G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 957-58 (5th Cir. 1981). Thus, courts often hold that the burden of proof is the same under each provision. *See, e.g.,* Pharo v. Smith, 621 F.2d 656, 673 (5th Cir. 1980); *see also* cases cited *infra* note 135.

30. H.R. 5480, 73d Cong., 1st Sess., 77 CONG. REC. 2910 (1933), *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 4, Item 27. Section 11 of the bill, however, did permit a director (or a person performing similar duties) or a partner to be held liable for false or misleading registration statements even if that person was not a director at the time of the distribution of the registration statement. *Id.*

31. In amending H.R. 5480, the original version of the 1933 Act that passed in the House, the Senate Committee on Banking and Currency deleted everything following the enacting clause of the bill and supplemented as an amendment S. 875, the Senate's version of what the 1933 Act should contain. *Compare* H.R. 5480, 73d Cong., 1st Sess., 77 CONG. REC. 2910 (1933) (as passed by the House), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 7 *with* S. 875, 73d Cong., 1st Sess., 77 CONG. REC. 2979-82 (1933) (as reported from the Senate Banking and Currency Committee), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 8.

Section 2(k) of S. 875 defined a dummy as "a person who holds a legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner." S. 875, 73d Cong., 1st Sess., 77 CONG. REC. 2979-82 (1933), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 8. Section 13 of the same bill prohibited "any person who is a 'dummy' for another to sign a registration statement without disclosing his principal." *Id.*

The House objected to the Senate's amendment, and a Conference Committee was called to propose a compromise. 77 CONG. REC. 3085 (1933), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 9. A compromise was reached and the conference report, which included the controlling person provisions, was ultimately adopted by both the House and the Senate as the 1933



dummy<sup>32</sup> in a way that prevented corporate directors from evading liability for false or misleading registration statements by using persons not involved with the company to sign the statements.<sup>33</sup> Subsequently, most of the dummy provisions were merged and incorporated into the final 1933 Act, a merger that created section 15's controlling person provision.<sup>34</sup> Unlike the deleted dummy provisions, however, Congress did not define controlling person,<sup>35</sup> noting only that control was to be interpreted broadly to permit the provision to have effect whenever control actually is exerted.<sup>36</sup>

The 1933 Act's controlling person provision originally did not provide an affirmative defense.<sup>37</sup> After enactment, however, the bill was criticized as too drastic and vague<sup>38</sup> because it seemed to permit holding a controlling person secondarily liable for merely having the potential to exercise control but not for actually exercising any control or influence.<sup>39</sup> Responding

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Act. 77 CONG. REC. 3903, 4009 (1933), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 4, Item 13.

32. *See supra* note 31.

33. The Senate was concerned that directors would seek to evade liability by appointing directors to serve on the board who had no actual authority to direct or manage corporate affairs. *Federal Securities Acts: Hearings on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73d Cong., 1st Sess. 122 (1933) (statement of Rep. Parker) ("You are going to have [the fraud] done through one or two men. You will have these dummies who do not care, and who will take chances."), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 20; *see* Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1115-16 (5th Cir. 1980) (discussing legislative history of §§ 15 and 20(a)); *SEC v. Management Dynamics*, 515 F.2d 801, 812 (2d Cir. 1975) (noting purpose of dummy provisions was to prevent evasion of securities laws); S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 17.

34. H.R. REP. NO. 152, 73d Cong., 1st Sess. 27 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 19.

35. *See* 15 U.S.C. §§ 77a-77aa (1982 & Supp. IV 1986) (no definition of controlling person supplied).

36. H.R. REP. NO. 85, 73d Cong., 1st Sess. 14 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18. The Committee on Interstate and Foreign Commerce further explained that the determination of control should not rest on a "mathematical formula," but should be determined on the unique facts of each case. *Id.*

37. *See* 15 U.S.C. § 77o (1982).

38. 78 CONG. REC. 8668 (1934) (remarks of Sen. Fletcher), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 10; *see* 78 CONG. REC. 7868 (1934) (Senator Maloney noted that securities industry was fearful of securities legislation and "[was] told it should be afraid of [the controlling person provisions]."), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8.

39. Congress acknowledged that it did not intend the controlling person provisions to provide liability for the mere existence of control. Rather, control must be "effectively exercised to bring about the action upon which li-

to that criticism, Congress in 1934 amended section 15, adding an affirmative defense that prohibited secondary liability if the controlling person had "no knowledge of or reasonable ground to believe in the existence of the [fraud]."<sup>40</sup>

At the same time it amended section 15 of the 1933 Act, Congress enacted the 1934 Act and used section 15 as a model for section 20(a), the 1934 Act's controlling person provision.<sup>41</sup> Section 20(a) provoked strong opposition and, like section 15, was criticized as conceptually vague.<sup>42</sup> Despite arguments that a definition was needed,<sup>43</sup> Congress thought it undesirable to define explicitly a controlling person.<sup>44</sup> It decided instead that

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ability is based." 78 CONG. REC. 8669 (1934) (memorandum suggesting amendments), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 10.

40. Pub. L. No. 73-291, § 208, 48 Stat. 881 (codified at 15 U.S.C. § 770 (1982)). The original draft of the § 15 amendment provided that "unless the act for which such controlled person is alleged to be liable . . . was not performed at the direction of the controlling person nor to enable such controlling person to evade liability." H.R. 9323, 73d Cong., 2d Sess., 78 CONG. REC. 8667-68 (1934) (as amended by the Senate), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 4, Item 29. Congress did not discuss why the original draft of § 15's affirmative defense was rewritten before being incorporated into the 1933 Act. The change in the words used in the original to those in the final amendment, however, is significant. The original wording required proof that the controlling person did not orchestrate or direct the fraud. The adopted affirmative defense is more difficult to prove because it requires showing that the controlling person did not act negligently rather than intentionally. *See infra* notes 145-60 and accompanying text.

41. *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6571 (1934) (noting that 1934 Act's controlling person provision was "taken verbatim" from 1933 Act), *reprinted in* 6 LEGISLATIVE HISTORY, *supra* note 4, Item 22.

42. Representative Hollister argued that the term *controlling person* was not even an existing legal term and thus would cause confusion in litigation. 78 CONG. REC. 8094 (1934), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8. He asked if any member of the House of Representatives could define the term. *Id.* When he did not receive a response, the Congressman moved to delete the entire provision from the bill. *Id.* at 8094-95.

Subsequently, courts have upheld the controlling person provisions despite further allegations that the concept of control under the acts is vague and indefinite in violation of the fifth amendment. *See, e.g., United States v. Wolfson*, 269 F. Supp. 621, 625 (S.D.N.Y. 1967).

43. 78 CONG. REC. 8094-95 (1934) (exchange between Reps. Hollister and Lea regarding controlling person provisions), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8.

44. *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934) *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 4, Item 18; *see also* 15 U.S.C. §§ 78a-78jj (1982 & Supp. IV 1986) (no definition supplied).

Despite courts' inconsistent definitions of a controlling person, Congress continually has refused to define a controlling person for purposes of secondary liability in statutes subsequent to the securities acts. Two years after

courts should determine controlling person status based on the facts presented in each case.<sup>45</sup>

Section 20(a) closely resembles section 15 of the 1933 Act, but the affirmative defense provided by the 1934 Act differs significantly from that in the 1933 Act.<sup>46</sup> The 1933 Act exculpates a controlling person who acted reasonably under the circumstances.<sup>47</sup> The 1934 Act, on the other hand, does not impose liability even if negligent conduct is proven as long as the controlling person acted in "good faith and did not . . . induce" the fraud.<sup>48</sup> Thus, the 1933 Act bases a controlling person's liability on an objective reasonable person standard,<sup>49</sup> whereas the 1934 Act uses a subjective good faith standard.<sup>50</sup>

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adopting the 1934 Act, Congress enacted the Public Utilities Holding Act and in 1940 the Investment Company Act. Both statutes were enacted to prevent opportunities for unfair treatment of investors. 2 L. LOSS, *supra* note 1, at 766. Both statutes repeatedly refer to the control concept and contain definitions. The Investment Company Act defines control as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position." 15 U.S.C. § 80a-2(a)(9) (1982). Any person owning 25% of the voting securities of the company is presumed to be in control. *Id.* Although the Public Utilities Holding Act does not explicitly define control, the terms *holding company* and *subsidiary company* are defined to include any company which "controls . . . with power to vote 10 per centum or more of the outstanding voting securities." 15 U.S.C. § 79b(7)-(8) (1982).

Even in the sections within those statutes that allow a controlling person to be held secondarily liable, there are no precise standards on which to base liability. See 15 U.S.C. § 80a-64 (1982) (provision allowing controlling person to be held secondarily liable). Additionally, in adopting § 13(c) of the Commodity Exchange Act in 1968, Congress modeled it after § 15 of the 1933 Act and § 20(a) of the 1934 Act. S. REP. NO. 384, 97th Cong., 2d Sess. 4 (1982). This provision also fails to state the exact basis on which to hold a controlling person liable. See 7 U.S.C. § 13(c) (1982).

45. 78 CONG. REC. 8095 (1934) (congressional rejection of motion to either delete controlling person provision or adopt definition), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8.

46. *Cf.* Note, *supra* note 29, at 839 (the controlling person provisions require distinct standards to impose liability).

47. See *infra* notes 114-28 and cases cited therein.

48. 15 U.S.C. § 78t(a) (1982).

49. See Note, *Liability of Controlling Persons—Common Law and Statutory Theories of Secondary Liability*, 24 DRAKE L. REV. 621, 635 (1975) (§ 15's affirmative defense must be scrutinized on factual basis with reasonable amount of objectivity).

50. See Note, *supra* note 11, at 1025 (good faith must be measured against subjective rather than objective standards).

Although the plain language of §§ 15 and 20(a) demonstrates Congress's intent to provide controlling persons with unique affirmative defenses, the legislative history of those provisions is surprisingly thin. Congress explicitly addressed *who* could be a controlling person, see H.R. REP. NO. 85, 73d Cong., 1st Sess. 14 (1933) (controlling status should not be limited to 51% of voting

## II. JUDICIAL INTERPRETATIONS OF SECTIONS 15 AND 20(a) OF THE 1933 AND 1934 SECURITIES ACTS

Congress's decision to leave controlling person undefined in both the 1933 and 1934 Acts has divided courts regarding the proper interpretation and application of the controlling person provisions.<sup>51</sup> Courts generally use a two-part test to determine

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power), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18, and noted that liability should not be based solely on the controlling person's position of influence without the exercise of any power, 78 CONG. REC. 8669 (1934), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 10. The legislative history, however, suggests nothing concerning the appropriate standard of culpability for controlling person liability. Moreover, industry representatives who criticized both the 1933 and 1934 Acts in extraordinary detail, *see, e.g., Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6639 (1934) (Mr. Whitney, President of the New York Stock Exchange, criticizing controlling person provisions), *reprinted in* 6 & 7 LEGISLATIVE HISTORY, *supra* note 4, Item 22, failed to express concern about Congress's lack of a definition of a controlling person or its failure to delineate the applicable standard of culpability.

Other commentators also have concluded that the legislative history concerning the controlling person provisions does not help in determining the standard of liability. *See, e.g., Ferrara & Sanger, supra* note 11, at 1012 (Congress did not address standard upon which to base controlling person's liability); Note, *supra* note 11, at 1023 (Congress devoted only single paragraph of legislative history to controlling person provisions); Note, *supra* note 49, at 628-29 (legislative history of controlling person provisions is short and vague).

51. *Compare Orloff v. Allman*, 819 F.2d 904, 906 (9th Cir. 1987) (Congress intended liability to be imposed only if controlling person participated in the fraud); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981) (to impose liability upon controlling person, intentional participation must be evidenced), *cert. denied*, 455 U.S. 938 (1982); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (§§ 15 and 20(a) impose liability only for intentional participation) *with Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (Congress intended liability to be imposed if controlling person was in position in which the fraud could have been discovered), *cert. denied*, 474 U.S. 1057, 1072 (1986); *Henricksen v. Henricksen*, 640 F.2d 880, 884 (7th Cir.) (controlling person need not participate in the fraud to be held liable), *cert. denied*, 454 U.S. 1097 (1981); *Richardson v. MacArthur*, 451 F.2d 35, 42 (10th Cir. 1971) (indirect means of discipline or influence is enough to hold controlling person liable).

Noting that the provisions were not defined in the acts, federal courts look to other sources for aid in devising a standard to use in determining if a person can be held liable under §§ 15 and 20(a) of the Acts. *See, e.g., Marbury Management v. Kohn*, 629 F.2d 705, 712-15 (2d Cir.) (considering common law secondary liability doctrines), *cert. denied*, 449 U.S. 1011 (1980). Courts frequently look to the definition promulgated by the Securities and Exchange Commission (SEC), which provides: "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, 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." 17 C.F.R. §§ 230.405, 240.12b-2 (1987).

secondary liability under the securities acts' controlling person provisions.<sup>52</sup> The first prong requires the complainant to demonstrate that the person occupied a position of control,<sup>53</sup> and the second prong demands a showing of some level of involvement in the controlled person's fraudulent activities.<sup>54</sup> Most courts construe the first requirement broadly, requiring only that the controlling person possess some indirect means of discipline or influence over the controlled person.<sup>55</sup> Although courts agree on this broad interpretation under the first prong

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The SEC construes the rule broadly and does not require intentional participation to hold a controlling person secondarily liable. See Speech by Commissioner A.A. Sommer, Jr., *Directors and the Federal Securities Laws* (criticizing recent Second Circuit case mandating intentional participation), reprinted in [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,669 (Feb. 27, 1974). Although courts note the SEC's interpretation, they do not necessarily rely upon it. See *Safeway Portland Employees' Fed. Credit Union v. C.H. Wagner & Co.*, 501 F.2d 1120, 1124 n.17 (9th Cir. 1974) (noting SEC definition but not relying upon it); *Leff v. C.I.P. Corp.*, 540 F. Supp. 857, 867 (S.D. Ohio 1982) (same). But see *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981) (citing 17 C.F.R. § 230.405(f) (1979)) (definitions adopted by SEC are standard to determine controlling person).

52. See, e.g., *Orloff*, 819 F.2d at 906 (plaintiffs must prove control and intentional participation); *Metge*, 762 F.2d at 631 (evidence must demonstrate that defendant actually participated in corporate operations and that defendant controlled specific transaction); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119-20 (5th Cir. 1980) (proof of control and good faith required to decide issues).

53. See, e.g., *Buhler v. Audio Leasing Corp.*, 807 F.2d 833, 835 (9th Cir. 1987) (complainant first must show that defendant had power and influence over controlled person). The first element of the test addresses *who* is a controlling person, not whether that person is liable. *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 548 (9th Cir. 1986).

54. See, e.g., *Kersh*, 804 F.2d at 549 (after determining defendant is controlling person, court must look at level of involvement in the fraud).

55. See, e.g., *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). The Eighth Circuit noted that the controlling person provision is remedial and should be construed liberally. *Myzel*, 386 F.2d at 738; cf. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (to effectuate purposes, provisions should not be construed technically); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 185 (1963) (provisions should be construed flexibly).

In accordance with Congress's anticipation of the countless ways to exercise control, see H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934) (although noting impossibility of defining controlling person, Committee on Interstate and Foreign Commerce did note examples of ways to exert control, including stock ownership, leases, contracts, and agencies), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 4, Item 18, courts impose few limitations on the categories of persons who meet the standard of controlling status. For an example of the broad interpretation of control, see *In re North Am. Acceptance Corp. Sec. Cases*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,258 (N.D. Ga. 1981) (holding that attorneys can be controlling persons) and cases cited *supra* note 7.

of the test,<sup>56</sup> they have failed to develop a uniform standard for the second part of the test.<sup>57</sup> In determining the extent of participation necessary to justify imposing secondary liability, some courts have adopted a broad interpretation of the controlling person provisions,<sup>58</sup> while other courts have construed those provisions narrowly.<sup>59</sup>

#### A. THE INTENTIONAL PARTICIPATION STANDARD OF SECONDARY LIABILITY

Under the second prong of the test, some courts require the complainant to prove actual participation before imposing secondary liability.<sup>60</sup> In *Rochez Bros. v. Rhoades*,<sup>61</sup> for example,

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56. See *Buhler*, 807 F.2d at 835 (complainant must first show defendant had influence over controlled person); *Pharo v. Smith*, 621 F.2d 656, 670-71 (5th Cir. 1980) (ownership of less than 10% interest in company not sufficient control); *Rochez Bros. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975) (must determine whether defendant had actual or potential control); *SEC v. Management Dynamics*, 515 F.2d 801, 812-13 (2d Cir. 1975) (evidence that defendant occupied prominent position within company); *Fey v. Walston & Co.*, 493 F.2d 1036, 1051 (7th Cir. 1974) (control aspect of vicarious liability is first element to consider); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969) (evidence of control over day-to-day operations sufficient to deem director controlling person).

57. Courts generally require a person to be either an intentional participant or to have been in a position in which the fraud could have been discovered. See *infra* text accompanying notes 51-89. But see *Holmes v. Bateson*, 583 F.2d 542, 560 (1st Cir. 1978) (using strict liability standard to hold company liable).

58. See *infra* notes 60-73 and accompanying text.

59. See *infra* notes 74-89 and accompanying text.

60. Although the circuits do not always adhere to one approach when determining secondary liability, the First, Second, Third, Fourth, Sixth, Seventh, and Ninth Circuits generally agree that to impose liability under the controlling person provisions, the controlling person must intentionally participate in the fraud. See *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 549 (9th Cir. 1986) (evidence of intentional participation establishes prima facie case of liability); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979) (controlling person will not be liable for failure to supervise), *cert. denied*, 444 U.S. 1045 (1980); *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 395 (4th Cir.) (although wavering on the issue, court seems to require intentional participation), *cert. denied*, 444 U.S. 868 (1979); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596 (3d Cir. 1976) (controlling person must be culpable confederate in the fraud); *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (controlling person must be shown to have knowingly used controlled person to be held liable), *cert. denied*, 420 U.S. 908 (1975); *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir.) (controlling person not liable because he was not an intentional participant), *cert. denied*, 414 U.S. 926 (1973); *Kravitz v. Pressman, Fröhlich & Frost, Inc.*, 447 F. Supp. 203, 212-13 (D. Mass. 1978) (failure to supervise will be considered intentional participation required to hold controlling person liable).

the Third Circuit interpreted sections 15 and 20(a) narrowly, requiring the complainant to prove that the controlling person intentionally participated in the controlled person's fraudulent activity.<sup>62</sup> Intentional participation may take the form of direct or indirect involvement in the fraud,<sup>63</sup> but in either case the controlling person must consciously intend to aid the fraudulent scheme.<sup>64</sup>

Courts interpreting the controlling person provisions to require intentional participation offer several justifications.<sup>65</sup> If intentional participation is not required, these courts reason, liability could be imposed solely because of the ability to influence or control securities activities without regard to the

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61. 527 F.2d 880 (3d Cir. 1975).

62. *Id.* at 890 (Congress would not have enacted controlling person provision while permitting liability to rest on something other than intentional participation). *Rochez Brothers* sued M.S. & R., Inc. and Charles Rhoades, the M.S. & R. president, for violations of Rule 10b-5. *Rochez Bros. v. Rhoades*, 353 F. Supp. 795, 799 (W.D. Pa. 1974). The district court found that Rhoades failed to disclose material information concerning possible buyers of the stock prior to an agreement to sell. *Id.* at 801. In a subsequent order, the court dismissed the suit against M.S. & R. *Rochez Bros. v. Rhoades*, No. 68-1048 (W.D. Pa. Jan. 22, 1973). On first appeal, however, the Third Circuit held that the district court did not make sufficient findings of fact to dismiss M.S. & R. *Rochez Bros. v. Rhoades*, 491 F.2d 402, 413 (3d Cir. 1974). On remand, *Rochez* asserted that M.S. & R. was a controlling person and could be held secondarily liable. *Rochez Bros. v. Rhoades*, 390 F. Supp. 470, 473-74 (W.D. Pa. 1974). The district court concluded that M.S. & R. was not a controlling person and had acted in good faith. *Id.* at 473. On a second appeal, the Third Circuit evaluated the legislative history of the statute and other court decisions and determined that M.S. & R. did not control Rhoades's activities and thus was not a controlling person. *Rochez Bros.* 527 F.2d at 889-91. The court further stated that even assuming that M.S. & R. was a controlling person, *Rochez* did not prove intentional participation on M.S. & R.'s part and thus the company could not be held secondarily liable. *Id.* at 891.

63. Intentional participation does not necessarily have to be active participation. *Rochez Bros.*, 527 F.2d at 890. In the case of inaction, it must be apparent that the controlling person intentionally furthered the fraud or prevented its discovery. *Id.*

64. *Id.* at 880; *see also Straub*, 540 F.2d at 596 (company's authorization and participation in scheme to defraud investor made company an intentional participant); *Coffey*, 493 F.2d at 1318 (controlling person must knowingly use controlled person to conduct fraud).

65. Some courts propose that because the standard of culpable (intentional) participation is "ever-present in the securities laws," it is reasonable that the controlling persons provisions include the same standard. *Rochez Bros.*, 527 F.2d at 885; *see also Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (arguing that use in 1933 Act of words like "cunning, manipulative, deceptive, . . . and lack of good faith, and absence of language indicating liability for negligent or non-negligent conduct" demonstrate intent that liability would not attach under controlling persons provisions unless element of culpability was present).

controlling person's actions.<sup>66</sup> Such a result would transform secondary liability into liability insurance, an approach Congress explicitly rejected.<sup>67</sup>

Courts adopting the intentional participation standard also argue that the Supreme Court has approved its use. In *Ernst & Ernst v. Hochfelder*,<sup>68</sup> the United States Supreme Court suggested that Congress intended section 20(a) of the 1934 Act to require more than mere negligence to establish liability.<sup>69</sup> Some lower courts have extended the Supreme Court's dicta to support their contention that a controlling person must intentionally participate in the securities fraud before a court can find liability under either the 1933 or the 1934 Act.<sup>70</sup>

Additionally, courts emphasize that policy considerations support the narrow interpretation of the controlling person provisions.<sup>71</sup> Unless intentional participation is the standard,

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66. See *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 550 (9th Cir. 1986) (prohibiting imposition of liability despite finding that defendant occupied influential position); see also *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978) (Congress adopted fiduciary standard proposed by the House); *Rochez Bros.*, 527 F.2d at 885 (asserting that "insurer's standard" rejected for "fiduciary standard").

67. The Senate's initial draft of the 1934 Act proposed an "insurer's" liability standard under which any corporate officer or director would be liable for violations committed by the corporation regardless of personal fault. S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 17. The Senate advocated this standard because several senators believed that if a controlling person could assert ignorance of the fraud, investors would rarely recover damages and confidence in the markets would not be restored. *Id.* Moreover, the Senate believed that if one of two innocent persons must bear a loss, "he . . . who has the opportunity to learn the truth and has allowed untruths to be . . . relied upon" should do so. *Id.* The House, however, felt that the Senate's proposed standard would be unfair and would not deter fraud, suggesting instead that holding controlling persons to a lesser standard would not impede honest business and would improve the standards of "honesty and fair dealings." H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18. In choosing between the two standards, the Senate accepted those imposed by the House bill. *Id.*

68. 425 U.S. 185 (1976).

69. The Supreme Court stated that § 20(a) of the 1934 Act requires a "state-of-mind condition requiring something more than negligence." *Id.* at 209 n.28. Courts adopting the intentional participation standard frequently refer to this dicta concerning § 20(a) but fail to acknowledge that the Supreme Court also stated that § 15 of the 1933 Act requires mere negligence to allow recovery from a controlling person. *Id.* at n.27.

70. See, e.g., *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir.) (citing *Ernst & Ernst* to support claim that both controlling person provisions require intentional participation), cert. denied, 444 U.S. 868 (1979); *Westlake v. Abrams*, 504 F. Supp 337, 349 (N.D. Ga. 1980) (same).

71. For example, one commentator has argued that because controlling



courts could hold controlling persons liable for virtually every unlawful act of their past or present employees and partners, regardless of the controlling person's complete lack of knowledge or involvement.<sup>72</sup> Allowing such a result is analogous to imposing strict liability, a standard clearly rejected by Congress in providing controlling persons with affirmative defenses. Moreover, such a strict standard would be unfair and inadequate to deter future fraudulent activities.<sup>73</sup>

#### B. THE NEGLIGENCE STANDARD OF SECONDARY LIABILITY

In contrast to those courts adopting the intentional participation standard, other courts have interpreted the controlling person provisions as requiring only negligent involvement in the fraud.<sup>74</sup> For example, in *G.A. Thompson & Co. v. Partridge*,<sup>75</sup> the Fifth Circuit interpreted sections 15 and 20(a)

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persons may not always know about the fraudulent activities subjecting them to secondary liability, an element of uncertainty enters. See Comment, *The Eighth Circuit and Secondary Liability Under the 1933 and 1934 Securities Acts—Metge v. Baehler*, 19 CREIGHTON L. REV. 887, 929-30 (1986). Permitting liability to rest on anything but intentional participation, therefore, would shift the balance between the investor's protection and the legitimate operations of a business "intolerably toward investor protection." *Id.* at 930.

72. *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); *accord SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (without requiring knowing participation in the fraud, every link in chain of command would be civilly liable for violations of inferior corporate agents), *cert. denied*, 420 U.S. 908 (1975).

73. *Cf.* Comment, *supra* note 70, at 889 (arguing that liberal standard would force controlling persons to insure customers against fraudulent activities perpetrated by their employees).

74. See *infra* note 84 and accompanying text.

75. 636 F.2d 945 (5th Cir. 1981). *G.A. Thompson & Co.*, a broker-dealer, sued Presley and others for a Rule 10b-5 violation. Presley, a director of a mortgage loan company, asserted that he could not be a controlling person because Thompson had failed to show that Presley had participated in the fraudulent activity. *Id.* at 957. The Fifth Circuit held that the proper elements to consider included whether Presley had the requisite power to control and whether Presley had satisfied the good faith defense. *Id.* at 958. Because Presley was a 24% stockholder, a director, and was involved in day-to-day coordination of the business, the court deemed Presley a controlling person. *Id.* Regarding Presley's defense, the court found that Presley could not have supervised or established a system of supervision over the controlled person engaged in the fraud, but the court nevertheless held that because Presley could have exercised his influence to minimize the chances of a Rule 10b-5 violation, he had not acted in good faith. *Id.* at 959.

The court characterized the standard it used to hold Presley liable as recklessness, *id.* at 959, but the standard is more accurately described as negligence. The court apparently based its mischaracterization on Supreme Court dicta stating that § 20(a) of the 1934 Act requires something more than negligence to hold a controlling person liable. *Id.* (citing *Ernst & Ernst v.*

broadly, holding a controlling person who could have deterred the fraud secondarily liable.<sup>76</sup> Under that standard, after the complainant proved that the defendant was in a position to influence the controlled person,<sup>77</sup> the burden shifted to the controlling person to establish the affirmative defense provided by Congress.<sup>78</sup>

Although agreeing that Congress did not intend to impose "insurer's liability" on controlling persons,<sup>79</sup> these courts assert that Congress predicated secondary liability upon something similar to a negligence standard.<sup>80</sup> The negligence approach imposes liability on controlling persons who breach the duty of care owed to third persons.<sup>81</sup> If a person commits securities fraud while under the supervision or influence of a controlling person, courts presume that the controlling person failed to exercise due care.<sup>82</sup> Courts do, however, permit the controlling person to demonstrate non-negligent conduct to rebut the pre-

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Hochfelder, 425 U.S. 185, 209 n.28 (1976)). The court viewed the failure to maintain supervisory programs as an encouragement to the fraud and thus held Presley liable. *Id.* at 959-60. Rather than permitting Presley to escape liability, the court apparently described his negligent conduct as reckless to conform with the Supreme Court's dicta.

76. *Id.* at 959-60.

77. *Id.* at 958. Some courts hold that a controlling person's ability to influence is sufficient alone to find liability. See *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967) (indirect means of discipline or influence enough to impose liability), *cert. denied*, 390 U.S. 951 (1968); *Dyer v. Eastern Trust and Banking Co.*, 336 F. Supp. 890, 916 (N.D. Me. 1971) (prima facie case made out when defendant shown to be one of 12 directors controlling corporation); *cf. Rochez Bros. v. Rhoades*, 527 F.2d 880, 884 (3d Cir. 1975) (ability to influence is relevant).

78. *G.A. Thompson & Co.*, 636 F.2d at 960 (controlling persons must establish affirmative defenses); *Terra Resources I v. Burgin*, 664 F. Supp 82, 88 (S.D.N.Y. 1987) (good faith is recognized defense); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 885 (S.D.N.Y. 1986) (defendant can escape liability by establishing statutory defense); *accord Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir.) (§ 20(a) provides good faith defense), *cert. denied*, 423 U.S. 1025 (1975).

79. See, e.g., *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980) (Congress rejected insurer's standard (citing H.R. CONF. REP. NO. 152, 73d Cong., 1st Sess. 27 (1933))).

80. Negligence is defined as a failure to do something that a reasonable person would do under similar circumstances or the doing of something that a reasonably prudent person would not do under the circumstances. See W. PROSSER & P. KEETON, TORTS § 30, at 164-65 (5th ed. 1984).

81. S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 17. The House Report accompanying the 1933 Act noted that the standard adopted required controlling persons to use "reasonable care" and "diligence." H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 19.

82. See, e.g., *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 915-16

sumption of liability.<sup>83</sup>

Courts advocating the negligence approach to secondary liability<sup>84</sup> argue that the intentional participation standard conflicts with Congress's intent because it improperly forces the complainant to disprove the controlling person's affirmative defenses. They suggest that Congress intended to place the burden of establishing an affirmative defense on the controlling person.<sup>85</sup> Consistent with that intention, the negligence standard requires the controlling person to establish an affirmative defense to defeat liability.<sup>86</sup> It does not, unlike the intentional participation standard, impose liability *only* if the complainant disproves the controlling person's defenses.

Courts also assert that the intentional participation standard contravenes Congress's intent to protect the public.<sup>87</sup> Because that standard imposes secondary liability only for

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(N.D. Me. 1971) (person in position of influence is prima facie controlling person and deemed to have participated in acts causing the loss).

83. See *Demarco v. Edens*, 390 F.2d 836, 841-42 (2d Cir. 1968) (defendant exculpated with evidence that he did not know, nor could have known, of the alleged misstatement or omission). Under the negligence standard, it is not sufficient for the defendant to demonstrate lack of participation or knowledge of the fraudulent activities. Rather the defendant must show diligence and due care. See *Cameron v. Outdoor Resorts of Am.*, 608 F.2d 187, 194-95 (5th Cir. 1979) (upholding district court's ruling because defendant failed to "diligently enforce a proper system of supervision and control") (quoting *DelPorte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1154 (5th Cir. 1977) (per curiam); *DelPorte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1154 (5th Cir. 1977) (per curiam) (defendant failed to maintain and enforce a control system).

84. The Fifth, Eighth, and Tenth Circuits reject the intentional participation standard. Although their opinions are sometimes ambiguous, those courts generally agree the complainant first must prove that the defendant occupies a position of control. The defendant must then respond, asserting an affirmative defense, which requires disproving something akin to negligence. See *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (simply stating intentional participation standard is erroneous for "reasons announced . . . in [*G.A. Thompson & Co.*]"), *cert. denied*, 474 U.S. 1057, 1072 (1986); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981) (controlling person must demonstrate implementation of reasonable system of supervision); *Richardson v. MacArthur*, 451 F.2d 35, 41-42 (10th Cir. 1971) (officers must act with due care and adopt precautionary measures to escape liability).

85. Note, *supra* note 25, at 1403-04 (intentional participation standard requires plaintiff to negate affirmative defenses, preventing controlling persons from demonstrating good faith and noninducement elements).

86. *Cf. SEC v. Geon Indus.*, 531 F.2d 39, 54 (2d Cir. 1976) (after complainant proved company was controlling person and company demonstrated reasonable care, court did not impose liability).

87. See *infra* text accompanying notes 103-13.

intentional involvement,<sup>88</sup> a controlling person in a position to discover fraudulent conduct will have a strong incentive to relax supervision and remain ignorant of the controlled person's activities.<sup>89</sup> By doing so, the controlling person prevents a finding of fraudulent intent and circumvents liability. A negligence standard, in contrast, prevents controlling persons from escaping liability based on lack of knowledge and encourages meaningful supervision that protects the public from fraud.

### III. ROCHEZ BROS., G.A. THOMPSON & CO., AND UNIFORM SECONDARY LIABILITY STANDARDS

Although courts apply different standards in determining a controlling person's liability, most courts agree that whichever standard is chosen, that standard should be used under both the 1933 and 1934 Acts.<sup>90</sup> Courts primarily use either the intentional participation standard, which demands proof that the defendant intentionally participated in the fraud,<sup>91</sup> or the negligence standard, which only requires proof that the defendant was a controlling person but allows the defendant to establish an affirmative defense.<sup>92</sup> Because neither standard is accurate under both Acts, courts should adopt different standards for each controlling person provision.

#### A. THE INTENTIONAL PARTICIPATION STANDARD: INADEQUATE UNDER BOTH SECURITIES ACTS

The intentional participation standard<sup>93</sup> provides a plausible interpretation of the congressional intent underlying the controlling person provisions.<sup>94</sup> Seeking to prohibit liability

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88. See *supra* notes 60-64.

89. One court has noted that the intentional participation standard would "give blessing to a hear-no-evil, see-no-evil approach," violating the statutes' remedial purposes. *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974). In contrast, a negligence standard would prevent escape from liability for lack of knowledge. See *G.A. Thompson & Co.*, 636 F.2d at 959.

90. See, e.g., *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980) (controlling person provisions are analogous and should be interpreted similarly).

91. See *supra* notes 60-73 and accompanying text.

92. See *supra* notes 74-89 and accompanying text.

93. See *Rochez Bros. v. Rhoades*, 527 F.2d 880, 884-86 (3d Cir. 1975); *supra* notes 60-73 and accompanying text.

94. The legislative history concerning Congress's intent in adopting the

based solely on a controlling person's influential position, Congress stated in the legislative history that more than mere control must be present to impose liability.<sup>95</sup> Because requiring proof of intentional participation precludes liability based solely on a position of control,<sup>96</sup> the intentional participation standard conforms to congressional intent.

The intentional participation standard, however, contravenes the statute's plain language.<sup>97</sup> Sections 15 and 20(a) mandate that the complainant prove the defendant was a

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1933 and 1934 Acts is ambiguous and arguably supports either the narrow or broad interpretation of the controlling person provisions. *See, e.g.*, Note, *supra* note 11, at 1012 (provisions are susceptible to varying interpretations). Other considerations, however, suggest the broad construction is a more accurate interpretation of §§ 15 and 20(a). *See infra* notes 135-76 and accompanying text.

95. Congress thought it unfair to impose secondary liability solely because a controlling person possessed authority over employees and has deeper pockets. Representative Hollister noted that no one would want to do anything "which would make it easy to attack an honest man under this bill merely because he may have wealth." 78 CONG. REC. 8094-95 (1934), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8. Consequently, the Senate amended § 15 of the 1933 Act, noting that the "mere existence of control is not . . . a basis for liability." 78 CONG. REC. 8669 (1934) (Sen. Fletcher's explanation of amendments to the 1933 Act), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 4, Item 10. Unless control is "effectively exercised" to bring about the fraud, the controlling person cannot be liable. *Id.*

96. *See Orloff v. Allman*, 819 F.2d 904, 907 (9th Cir. 1987) (owner of investment corporation escaped liability because there was no evidence of participation in the fraud); *Kersh v. General Council of the Assemblies of God*, 804 F.2d 546, 551-53 (9th Cir. 1986) (church headquarters deemed in control of local church, but not liable because no evidence of intentional participation); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981) (company held liable for employee's conduct only after finding company was participant in the fraud), *cert. denied*, 455 U.S. 938 (1982); *Herm v. Stafford*, 663 F.2d 669, 685 (6th Cir. 1981) (director not liable because no evidence of participation); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (same); *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 39-40 (7th Cir.) (partners in brokerage firm not liable because they had no knowledge of the fraud), *cert. denied*, 414 U.S. 926 (1973).

97. Statutory analysis always begins with an examination of the language of the statute. *See, e.g.*, *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985) (axiomatic that starting point in every case involving construction of statute is language itself). Courts only consult legislative history when the statutory expression is ambiguous. *Maine v. Thiboutot*, 448 U.S. 1, 6 n.4 (1980). Moreover, courts should be reluctant to resort to legislative history when it is used to support a result *contrary* to the statute's express terms. *See ACLU v. Federal Communications Bd.*, 823 F.2d 1554, 1560, 1564 (D.C. Cir. 1987); *accord Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976) (in construing securities acts, "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must . . . rest primarily on the language of that section"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1973) (starting point in every case involving construction of statute is language itself).

controlling person; the controlling person then may assert an affirmative defense to defeat liability.<sup>98</sup> By requiring evidence demonstrating an intent to further the fraud, the courts force the complainant to prove negligence or bad faith, the affirmative defenses Congress gave to controlling persons. Courts using the intentional participation standard therefore place the defendant's burden on the complainant, rendering the defenses superfluous.<sup>99</sup>

Moreover, the intentional participation standard makes the entire controlling person provision unnecessary.<sup>100</sup> If the controlling person intentionally participated in the fraud, either directly or indirectly, that person could be held primarily liable for the violation.<sup>101</sup> Thus, invoking the controlling person provision would be unnecessary.<sup>102</sup> Congress would not have enacted a separate provision to impose secondary liability on a controlling person if the person also could be found primarily liable.

Perhaps more importantly, the intentional participation standard undermines the central purpose of the securities acts.<sup>103</sup> Congress provided investors a cause of action for losses

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98. Although the intentional participation standard interferes with the affirmative defenses, *see supra* text accompanying notes 84-86, courts using the standard still note that Congress provided these defenses. *See, e.g., SEC v. Savoy Indus.*, 587 F.2d 1149, 1170 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).

99. *See supra* notes 84-86 and accompanying text.

100. One of the primary canons of statutory interpretation is to avoid a construction of a statute that renders any part unnecessary. *See Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta*, 458 U.S. 141, 163 (1982) (construction of legislation so as to render part of it nugatory " 'offend[s] the well-settled rule that all parts of a statute, if possible, are to be given effect' ") (quoting *American Textile Mfrs. Inst. v. Donovan*, 452 U.S. 490, 513 (1981)).

101. Under § 11 of the 1933 Act, for example, a person purchasing stock may sue any person who took part in the preparation of a registration statement containing material misstatements. 15 U.S.C. § 77k(a) (1982). If the controlling person was a "culpable participant" and intentionally furthered the fraud by aiding in enclosing the false statements in the registration statement, that person can be held primarily liable under § 11 and there would be no need to invoke § 15. *Cf. Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 689 (5th Cir. 1971) (defendant held liable under § 11 for intentional participation in the fraudulent registration statement); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 894 (E.D. Pa. 1978) (requiring intent to defraud would mean § 20(a) would apply only when controlling person's primary liability can be shown), *cert. denied*, 455 U.S. 938 (1982).

102. *Cf. Hill York Corp.*, 448 F.2d at 689, 694-95 (holding defendant both secondarily and directly liable for participation in fraudulent transaction).

103. *See supra* notes 1-2.

caused by fraudulent activities<sup>104</sup> to restore investor confidence in the integrity and stability of the securities markets.<sup>105</sup> Requiring proof that the controlling person orchestrated or intentionally furthered the fraud imposes an evidentiary burden virtually impossible to satisfy.<sup>106</sup> In most cases the investor deals exclusively with the controlled person and will not have met or even dealt indirectly with the controlling person.<sup>107</sup> As a result, it is difficult for an investor to uncover proof that the controlling person *intended* to defraud her,<sup>108</sup> and proof that the controlling person only knew of the fraud will be insufficient to impose liability.<sup>109</sup> Requiring proof of intentional par-

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104. See generally 78 CONG. REC. 7866 (1934) (securities acts endeavor to remove possibility of future fraud and to protect small banks and investors from losses if fraud occurs), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 4, Item 8. But see *In re Olympia Brewing Co. Sec. Litig.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461, at 92,816 (N.D. Ill. 1981) (securities acts are primarily intended to deter fraudulent conduct, not to insure compensation to injured parties).

105. 77 CONG. REC. 2914 (1933) (remarks of Rep. Greenwood), reprinted in 1 LEGISLATIVE HISTORY, *supra* note 4, Item 7; see *supra* note 4.

106. Frequently, the controlled person is a salesperson or broker who either disappears or has only limited financial resources, leaving the investor without compensation for the loss. Cf. *SEC v. First Sec. Co.*, 463 F.2d 981, 993 (7th Cir.) (after conducting fraudulent transactions, president committed suicide), *cert. denied*, 409 U.S. 880 (1972). Thus the investor prefers to sue the party with the "deepest pockets." See Note, *supra* note 29, at 824. Congress, however, specifically stated it did not want actions to be brought solely because of a controlling person's wealth. See *supra* note 95.

107. Cf. *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 685 (5th Cir. 1971) (defendants orchestrated nationwide franchise operation but did not actually conduct the fraudulent transactions).

108. Plaintiffs cannot be expected to have personal knowledge of the facts constituting the wrongdoings in securities fraud. *Wool v. Tandem Computers*, 818 F.2d 1433, 1442 (9th Cir. 1987); see *Morris v. Gilbert*, 649 F. Supp. 1491, 1495 (E.D.N.Y. 1986) (controlled person's relationship to controlling person is better known to controlling person than to complainant); Note, *supra* note 29, at 842 (it is much easier to "screen the adequacy of a broker-dealer's supervisory procedures than it is to probe the corporate mind").

109. For example, in *Herm v. Stafford*, 663 F.2d 669 (6th Cir. 1981), defendant Dinkler was a director of Daniel Boone Fried Chicken. As a promotion in the issuance of stock, the company issued a press release that grossly overstated Daniel Boone's position in the market and its future prospects. *Id.* at 673. Dinkler read the release and staged a signing for a promotional picture with other directors. The company became insolvent and Dinkler was sued as a controlling person. He defended by arguing that he merely scanned the release and was unaware that he was a director. *Id.* at 674. The court held Dinkler could not be liable because there was no showing that he exercised any control over the corporation or the transaction. *Id.* at 684. For discussion of the court's mandate that conscious intent must be proved, see *supra* notes 60-64 and accompanying text.

ticipation, therefore, effectively shields a controlling person from liability and prevents investors from recovering losses.

The intentional participation standard also fails to deter securities fraud, another fundamental purpose underlying the controlling person provisions.<sup>110</sup> To avoid liability under this standard, controlling persons will attempt to show that they could not have intentionally furthered the fraud. Demonstrating a lack of knowledge of the fraudulent transaction would provide persuasive evidence that the controlling person did not intend to defraud an investor.<sup>111</sup> Thus, the less involved the controlling person is in the controlled person's activities, the less likely a court will find that the controlling person had the requisite intent.<sup>112</sup> Rather than promoting close supervision of employees to ensure compliance with the securities laws, the intentional participation standard encourages a controlling person to remain ignorant of all transactions, thereby avoiding secondary liability.<sup>113</sup> The intentional participation standard, therefore, although arguably consistent with some legislative history, is seriously flawed and should not be used to determine a controlling person's liability under either the 1933 or the 1934 Acts.

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110. See *supra* notes 1-2.

111. See *Herm*, 663 F.2d at 684.

112. Failing to maintain a reasonable system of supervision does not rise to the level of intentional participation. *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 551-53 (9th Cir. 1986); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1135 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

113. In the context of a Rule 10b-5 case, for example, one court noted that a firm should not be shielded from compensating victims who suffered losses from reckless conduct because such a result encourages partners to immunize themselves from liability by constructing a "Chinese wall" between themselves and their employees. *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 184 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). The court in *Sharp* was concerned that requiring partners to be knowing participants was a powerful disincentive to supervise employees. *Id.* The same court, however, employed the intentional participation standard to determine a controlling person's liability. *Id.* at 185. Yet the same arguments that support the use of a recklessness standard in Rule 10b-5 cases should apply to some cases arising under the controlling person provisions. Requiring a controlling person to be an intentional participant in the fraud encourages the controlling person to remain ignorant of the potentially fraudulent acts of her employees. See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1985); see also Note, *supra* note 11, at 1028 (policy considerations with respect to liability under Rule 10b-5 and controlling person provisions are closely related).



B. THE NEGLIGENCE STANDARD: ADEQUATE UNDER THE 1933 ACT, INADEQUATE UNDER THE 1934 ACT

The *G.A. Thompson & Co.*<sup>114</sup> negligence standard provides a more plausible interpretation of the controlling person provisions than the intentional participation standard.<sup>115</sup> The legislative history demonstrates that Congress intended controlling persons to act as fiduciaries<sup>116</sup> and as a result imposed a duty of care on them under both Acts to exercise their influence to detect and prevent fraudulent activities by controlled persons.<sup>117</sup> The negligence standard, which imposes secondary liability on controlling persons who reasonably could have discovered the controlled person's fraud,<sup>118</sup> comports with this duty to exercise care and competence.<sup>119</sup> Because the controlling person provisions have unique affirmative defenses and the 1933 and 1934 Acts regulate different activities,<sup>120</sup> the negligence standard is consistent with the standard Congress intended under the 1933 Act but fails under the 1934 Act.

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114. 636 F.2d 945 (5th Cir. 1981); *see supra* notes 75-89 and accompanying text.

115. *See* 2 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 5.10(410) (1986) (broader standard is better interpretation of controlling persons provisions).

116. H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933), *reprinted in* 2 *LEGISLATIVE HISTORY, supra* note 4, Item 18.

117. *G.A. Thompson & Co.*, 636 F.2d at 959. Courts implement this standard by mandating programs of supervision. *See* *Cameron v. Outdoor Resorts of Am.*, 608 F.2d 187, 194 (5th Cir. 1979) (president who failed to implement proper system of supervision held liable), *aff'd on reh'g in pertinent part, vacated and remanded in part*, 611 F.2d 105 (5th Cir. 1980); *DelPorte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1154 (5th Cir. 1977) (*per curiam*) (without supervisory programs, company held liable under controlling persons provisions); *Campbell v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,082, at 91,414 (N.D. Ill. 1985) (evidence of failure to supervise is *prima facie* case for liability).

Because investors generally come to a firm and not to a specific individual, courts often impose on controlling persons an affirmative obligation to prevent controlled persons from using the firm's prestige to defraud the investing public. *See* *Holloway v. Howerdd*, 536 F.2d 690, 696 (6th Cir. 1976) (holding defendant brokerage firm liable to investors who believed broker was working with firm in transaction); *see also* *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980) (investors relying on firm's prestige, rather than individual broker, may hold firm accountable for losses due to fraud).

118. *G.A. Thompson & Co.*, 636 F.2d at 959; *see supra* text accompanying notes 74-89.

119. *See* H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933), *reprinted in* 2 *LEGISLATIVE HISTORY, supra* note 4, Item 18.

120. *See supra* note 6 and text accompanying notes 18-29.

### 1. Application of a Negligence Standard Under Section 15 of the 1933 Act

In addition to the legislative history indicating that the negligence standard is appropriate, the plain meaning of section 15 of the 1933 Act requires the use of a reasonable person standard.<sup>121</sup> Section 15 holds a controlling person liable for the controlled person's fraudulent activities unless the controlling person lacked knowledge of the fraud or could not *reasonably* have known of the fraudulent conduct.<sup>122</sup> Under section 15, therefore, a controlling person must act as a reasonable person in a similar position would act to deter, discover, and prevent fraudulent transactions by controlled persons.<sup>123</sup> Under the intentional participation standard, however, a controlling person could escape liability, although grossly negligent, if the complainant lacks proof of intentional participation in the fraud.<sup>124</sup> Such a result contradicts section 15's language, which unambiguously imposes liability if a controlling person reasonably could have known of the fraud.<sup>125</sup>

The negligence standard also deters fraudulent securities transactions more effectively than the intentional participation standard.<sup>126</sup> Imposing secondary liability on controlling persons who could have known of the fraud, rather than only for intentional participation, creates a greater incentive for controlling persons to supervise closely all employees to discover and halt quickly any fraudulent activity.<sup>127</sup> If the controlling person

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121. See *supra* note 6.

122. See *supra* note 6.

123. Congress noted that "[d]irectors should assume the responsibility of directing and . . . should be held responsible to the unsuspecting public for their neglect." H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18; cf. *Demarco v. Edens*, 390 F.2d 836, 842 (2d Cir. 1968) (defendant not liable with evidence of reasonable care and prudence).

124. See *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 37 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); *infra* note 126.

125. See *supra* notes 6, 94.

126. Allowing a brokerage firm to avoid secondary liability simply by showing that it was not an intentional participant would allow it to escape liability by showing ignorance. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980). Instead, rather than merely evidencing ignorance of the fraud, the negligence standard requires a controlling person to demonstrate an effective system of supervision. *Id.* at 1119; see *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 439 (N.D. Cal. 1968) ("most effective means for insuring adequate supervision is to impose liability for injury resulting from its absence") (quoting *Lorenz v. Watson*, 258 F. Supp. 724, 733 (E.D. Pa. 1966)), *modified*, 430 F.2d 1202 (9th Cir. 1970).

127. In *Sennott*, the son of a partner in a securities firm conducted fraudu-

does not have a system of supervision to identify fraudulent conduct and the court determines that a reasonable person would have implemented and maintained such a program, the negligence standard will impose liability.<sup>128</sup>

## 2. Application of a Negligence Standard Under Section 20(a) of the 1934 Act

Although well-suited for the 1933 Act, the negligence approach is inappropriate for section 20(a) of the 1934 Act.<sup>129</sup> Section 20(a) was intended to impose secondary liability on a controlling person for the fraudulent acts of controlled persons unless the controlling person acted in good faith and did not induce the fraud.<sup>130</sup> By equating section 20(a)'s bad faith language with a negligence standard, courts erroneously interpret the affirmative defense of section 20(a)<sup>131</sup> because bad faith differs from mere negligence. Bad faith requires a showing of intentional or reckless conduct whereas negligence simply requires proof of conduct lacking due care.<sup>132</sup> Thus, applying a negligence standard under section 20(a) allows courts to hold controlling persons liable even when there is no evidence of bad faith, a result not contemplated by Congress.

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lent transactions under the name of his father's firm. 474 F.2d at 33-34. Although the firm discovered the fraud, it failed to stop the fraudulent activities. *Id.* at 37-39. The Seventh Circuit did not impose liability on the firm as a controlling person because it did not participate in the fraud. *Id.* at 39-40. Had the firm been threatened with liability, it may have more actively attempted to stop the fraudulent transaction. Indeed, two Supreme Court Justices thought that because the controlling person provisions are remedial, they should be construed more liberally than the lower courts permit. *Sennott v. Rodman & Renshaw*, 414 U.S. 926, 931 (1973) (Douglas & Blackmun, JJ., dissenting from denial of certiorari). The Justices further noted that firms should take precautionary measures to prevent losses to investors. *Id.*

128. *See supra* notes 74-89.

129. *See Hughes v. Dempsey-Tegler & Co.*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,133, at 94,551 (C.D. Cal. 1973) (controlling person "cannot be held accountable for that which it did not intend, nurture . . . or otherwise induce"); *cf. Smith v. Christie*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,828, at 90,121 (N.D. Cal. 1980) (if adequate system of supervision is implemented, mere failure to uncover alleged securities violations does not demonstrate bad faith).

130. *See supra* note 6.

131. *Cf. Gould v. American Hawaiiin S.S. Co.*, 351 F. Supp. 853, 860 n.7 (D. Del. 1972) (difference between scienter requirement in Rule 10b-5 and good faith defense under § 20(a) is merely a shift in burden of proof from plaintiff to defendant).

132. *See Note, supra* note 11, at 1025-26 (without indication from Congress, lack of good faith in the context of § 20(a) means more than lack of reasonable care).

Moreover, distinguishing good faith from bad faith is a subjective process, requiring a variable standard that evaluates each controlling person's conduct based on the facts of the case.<sup>133</sup> A negligence standard, however, is objective, allowing the use of a uniform standard in which the controlling person's conduct is compared to a reasonable person in similar circumstances.<sup>134</sup> Applying a negligence standard under section 20(a) of the 1934 Act, therefore, disregards the affirmative defense's plain meaning<sup>135</sup> by imposing an objective standard to evaluate a controlling person's conduct, when the language of the statute requires use of a subjective standard.

### C. AFFIRMATIVE DEFENSES REQUIRE DIFFERENT STANDARDS TO PROPERLY IMPLEMENT CONTROLLING PERSONS PROVISIONS

Courts enforcing sections 15 and 20(a) assume the provisions are similar and require identical interpretations.<sup>136</sup> The controlling person provisions, however, are significantly different in content.<sup>137</sup> Few courts recognize that Congress may not

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133. See *supra* note 50.

134. See *supra* note 80.

135. See *supra* notes 97, 100. Another problem with using the negligence standard under § 20(a) of the 1934 Act is that it may allow recovery when a court has determined that a complainant should not recover under the substantive provision violated. For example, in a Rule 10b-5 action, courts use a scienter standard to determine primary liability. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979). If the complainant cannot recover from the person who primarily violated Rule 10b-5 because evidence of scienter is lacking, then allowing the complainant to recover under the controlling person provision merely because there is evidence of negligence would undermine Rule 10b-5. See Note, *supra* note 11, at 1027-28.

136. See *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981) (courts should give §§ 15 and 20(a) the same interpretation); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980) (controlling person provisions are analogous and should be interpreted similarly); *Pharo v. Smith*, 621 F.2d 656, 673 (5th Cir. 1980) (§§ 15 and 20(a) of securities acts should be interpreted identically); *SEC v. Management Dynamics*, 515 F.2d 801, 812 (2d Cir. 1975) (§ 20(a) is analogue of § 15); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1309-10 n.5 (E.D. Va. 1981) ("The availability of controlling person liability is the same under either § 15 or § 20(a), despite the variations in language.").

For another suggestion of why courts are unable to develop a uniform standard, see Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. PA. L. REV. 1345, 1352-53 (1978) (suggesting that the need to rely on unique factual nature in each case has prevented development of universal standard).

137. Another important distinction between the two controlling person provisions is that § 15 of the 1933 Act imposes secondary liability only for vio-

have intended the same secondary liability standard to apply to both securities acts.<sup>138</sup>

To impose secondary liability correctly on a controlling person, courts should apply different standards of liability under each securities act.<sup>139</sup> Under section 15 of the 1933 Act, courts should base liability on a broad negligence standard,<sup>140</sup> whereas under section 20(a) of the 1934 Act, courts should use a narrower recklessness standard.<sup>141</sup> Despite these differentiated standards for establishing secondary liability, the first element of the test remains the same: the complainant must demonstrate that the defendant occupied a position of control or influence.<sup>142</sup> It is with the second element—the affirmative defense—that the standards differ. To defeat liability under section 15, the controlling person must establish nonnegligent conduct.<sup>143</sup> Under section 20(a), however, the defendant need only prove good faith by evidencing that the conduct at issue

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lations of §§ 11 and 12 of that Act, while § 20(a) of the 1934 Act imposes liability for virtually any violation of that Act. *See supra* note 6; 2 A. BROMBERG & L. LOWENFELS, *supra* note 115, § 5.10(410). *But see* Ferrara & Sanger, *supra* note 11, at 1012 (difference between two controlling person provisions is not significant).

138. *See* 2 A. BROMBERG & L. LOWENFELS, *supra* note 115, § 5.10(436) (no judicial focus or analysis on difference between controlling person provisions). *But see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-09 n.28 (1976) (noting that § 15 of 1933 Act “allow[s] recovery for negligent conduct,” but that “[e]ach of the provisions of the 1934 Act that expressly create civil liability . . . contains a state-of-mind condition requiring something more than negligence” (citing § 20(a) of 1934 Act as example)).

Although courts do not focus on the difference between the provisions, some commentators suggest the controlling person provisions are quite different and the affirmative defenses require different standards of proof. *See, e.g.*, 3 L. LOSS, *supra* note 1, at 1747 (1934 Act provides “seemingly readier defense than the 1933 Act”).

139. The Supreme Court has held that the 1933 and 1934 Acts need not be interpreted identically even if both use the exact same words. *See* 1 A. BROMBERG & L. LOWENFELS, *supra* note 114, § 4.6(312) (arguing that definition of security could be more broadly interpreted under 1934 Act than under 1933 Act). *Compare* Wilko v. Swan, 346 U.S. 427, 438 (1953) (predispute agreement violates § 14 of 1933 Act) with Shearson/American Express v. McMahon, 107 S. Ct. 2332, 2339 (1987) (some arbitration agreements are valid under § 29(a) of 1934 Act). *But see* Ferrara & Sanger, *supra* note 11, at 1012 (controlling person provisions should be construed identically).

140. *Ernst & Ernst*, 425 U.S. at 208-09 n.27 (§ 15 allows recovery for negligent conduct). For discussion of the negligence standard applied to § 15, see *supra* notes 114-28 and accompanying text.

141. *Ernst & Ernst*, 425 U.S. at 209 n.28 (§ 20(a) requires state of mind of something more than negligence).

142. *See supra* text accompanying notes 52-55.

143. For the definition of negligence, see *supra* note 80.

was not reckless.<sup>144</sup>

Requiring a controlling person to prove due care under the 1933 Act to satisfy the objective reasonable person standard is neither novel nor unreasonable<sup>145</sup> because the language of section 15 anticipates the use of a negligence standard.<sup>146</sup> Congress assumed that a reasonable person in a controlling position would attempt to discover fraudulent activities and endeavor to halt the conduct to prevent any loss to investors.<sup>147</sup> If a person reasonably could have known of the fraud but did not, that person was negligent and courts should impose liability regardless of the lack of actual knowledge.<sup>148</sup>

The broad purpose of the 1933 Act also requires that a controlling person act reasonably. Congress enacted the 1933 Act primarily to regulate initial stock offerings<sup>149</sup> and to protect in-

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144. Recklessness involves the state of mind of an actor who pays no regard to the possibility or probability of injury that could come about, or though seeing probable consequences, continues despite that knowledge. W. PROSSER & P. KEETON, TORTS § 34, at 213-14 (5th ed. 1984). Recklessness requires more than mere negligence. *Id.*, § 8, at 36; see *infra* note 179.

145. The House Report accompanying H.R. 5480 and § 15 discussed civil liabilities provisions incorporated into the bill as requiring a negligence standard:

The character of civil liabilities imposed by this bill . . . consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary . . . . Directors should assume the responsibility of directing . . . , [and] they should be held responsible to the unsuspecting public for their *neglect*.

H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18. Additionally, the report noted that "[t]he demands of this bill call for the assumption of no impossible burden" on the controlling person. *Id.*

146. See *supra* note 6. Commentators also assert that the best construction of the 1933 Act allows an escape from liability only if the controlling person exercised the reasonable care of a person of ordinary prudence. See Note, *supra* note 29, at 839-41. See also Folk, *Civil Liabilities under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 199, 216-24 (1969) (suggesting that controlling person under § 15 of 1933 Act must exercise reasonable degree of care).

147. Congress believed that holding persons involved in securities transactions to standards of "honesty, care, and competence" would cause corporate organization and practice to change in a way that would protect innocent investors from fraud. H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18.

148. For example, a director who negligently made false statements regarding a company's financial condition in a press release was not held liable because the court applied an intentional participation standard. *Herm v. Stafford*, 663 F.2d 669, 684-85 (6th Cir. 1981). If the court had used a negligence standard instead, the director would have been liable, resulting in a change in corporate practice that would prevent such negligence in the future.

149. Section 12(2) of the 1933 Act, which the controlling person provision

vestors in those transactions<sup>150</sup> by requiring persons proposing the issue to distribute detailed information regarding the character of the securities offered.<sup>151</sup> Investors rely on the accuracy of the information disclosed to appraise realistically the merits of the offering<sup>152</sup> and risk loss if due care is not taken to assure the information's accuracy.<sup>153</sup> Holding controlling persons to a negligence standard provides a strong incentive for the issuer to verify all information related to the offering,<sup>154</sup> which in turn promotes investor confidence in the securities markets and deters fraudulent activities. Thus, the negligence standard fulfills Congress's objectives in enacting the 1933 Act.<sup>155</sup>

Furthermore, imposing a negligence standard under section 15 of the 1933 Act would not unfairly burden a controlling person by lowering the threshold for suits asserting secondary liability because the 1933 Act contains other procedural

incorporates, however, is not limited to new issues and distributions despite its prominent mention of the prospectus. See 15 U.S.C. § 77l(2) (1982). See also *supra* note 1.

150. See SEC v. Ralston Purina Co., 346 U.S. 119, 124 n.10 (1953); Bush v. Carpenter, 827 F.2d 653, 656 (10th Cir. 1987); see also *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, Fed. Sec. L. Rep. (CCH) No. 1178, pt. II, ¶ 201, at 23 (May 21, 1986) (2d ed.) ("The keystone of the Securities Act of 1933 is the accurate disclosure of facts that will place potential securities purchasers on a par with persons seeking to issue securities and sell them to the public.").

151. Information required in a registration statement includes the name of the issuer, the general character of business transacted by the issuer, statements of capitalization, the specific purpose and amounts devoted to the purpose for which the security to be offered is to supply funds, and the estimated net proceeds to be derived from the security offering. See 15 U.S.C. § 77aa (1982 & Supp. IV 1986) (schedule of information required in registration statement); SEC Regulation S-K, 17 C.F.R. § 229 (1986) (instructions for filing forms under securities acts).

152. H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933) (items required to be disclosed are indispensable to accurate judgment on securities), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 4, Item 18.

153. See *Frankenstein v. McCrory Corp.*, 425 F. Supp. 762, 763 (S.D.N.Y. 1977) (investors experienced significant losses following inaccurate disclosure); see also *Herm v. Stafford*, 663 F.2d 669, 672 (6th Cir. 1981) (plaintiffs purchased or received stock in merger following inaccurate disclosure).

154. See 1 A. BROMBERG & L. LOWENFELS, *supra* note 115, § 2.3(800):

It makes sense for a higher standard of care (by way of the very narrow defense) to be imposed on those who are responsible for the preparation of a registration statement, since the latter is the heart of the public disclosure system for public offerings, and is widely relied on both directly and indirectly, e.g. through the component prospectus.

*Id.*; see also *Globus v. Law Research, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (1933 Act was designed to deter negligence by providing penalty for those who fail in their duties), *cert. denied*, 397 U.S. 913 (1970).

155. For the objectives of Congress, see *supra* notes 1-2.

protections that deter colorless claims.<sup>156</sup> For example, section 13 provides a one-year statute of limitations for bringing actions against a controlling person.<sup>157</sup> This provision assures that liability is not imposed after a lapse of time makes it more difficult to produce evidence proving compliance with the reasonable person standard.<sup>158</sup> Additionally, if a court considers a complaint frivolous, it can require the complainant to post a bond for costs, including attorneys' fees.<sup>159</sup> If the litigation goes forward, the court will, in certain circumstances, assess costs at the conclusion of the litigation.<sup>160</sup> These protections ensure that using a negligence standard, which makes it easier for complainants to state a cause of action, will not open the door to nonmeritorious claims, which would subject the controlling person to the cost and embarrassment of defending against them.

Although Congress intended a negligence standard to apply under the 1933 Act, a stricter standard should be required

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156. Congress regarded these restrictions on private damages actions as significant. When amending the 1933 Act, Senator Fletcher indicated that the procedural protections adopted were "the most important of all." 78 CONG. REC. 8669 (1934), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 4, Item 10.

157. 15 U.S.C. § 77m (1982). Both §§ 11 and 12 of the 1933 Act require the complainant to bring actions within one year after discovering the untrue statement or after such discovery should have been made through the exercise of reasonable diligence. *Id.*

158. *Cf. Herm v. Stafford*, 663 F.2d 669, 682-83 (6th Cir. 1981) (upholding summary judgment against defrauded investor because complaint filed 15 months after one-year limitation period expired). In addition to avoiding problems associated with stale evidence, a one-year statute of limitations relieves a controlling person from the worry of possible lawsuits. *See Wilson v. Garcia*, 471 U.S. 261, 275 n.34 (1985) (potential defendants' ability to know when they are free from worry of litigation is important policy consideration for statutes of limitations).

159. 15 U.S.C. § 77k(e) (1982).

160. If the court believes that a suit or a defense under the controlling person provisions is without merit, it will assess costs and fees. *See, e.g., Zissu v. Bear, Stearns & Co.*, 805 F.2d 75, 80-81 (2d Cir. 1986) (ordering plaintiff to pay costs for what court considered frivolous suit); *see also Henkel, Codification—Civil Liability Under the Federal Securities Laws*, 22 BUS. LAW. 866, 871 (1967) (discussing courts' discretion in mandating payment of costs).

Controlling persons are further protected because the complainant does not get relief simply by proving the existence of false and misleading statements. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 325 n.2 (1979). The complainant must also prove injury and damages. *Id.* The controlling person, therefore, will not be secondarily liable, even for gross negligence, if the complainant does not prove damages. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (suit dismissed because plaintiff failed to demonstrate that securities would be worth more if registration statement did not contain material omissions).



before liability is imposed on a controlling person under the 1934 Act.<sup>161</sup> The language of section 20(a) of the 1934 Act imposes liability unless the controlling person proves good faith. Because a controlling person can simultaneously act negligently and in good faith,<sup>162</sup> the negligence standard is inadequate for the 1934 Act.

In addition to the language of section 20(a), numerous differences between the Acts make a negligence standard impractical under the 1934 Act and suggest that the 1934 Act anticipates a narrower standard.<sup>163</sup> The 1934 Act primarily regulates the trading market rather than the new issue market and attempts to protect investors from fraudulent transactions on the securities exchanges.<sup>164</sup> Unlike the 1933 Act, which regulates the relatively few initial offerings,<sup>165</sup> the 1934 Act regulates millions of daily transactions executed by thousands of controlled persons.<sup>166</sup> Most transactions regulated by the 1934 Act are virtually impossible for a controlling person to supervise closely.<sup>167</sup> Consequently, given the vast number of transactions regulated and the impracticability of close supervision, holding a controlling person to a standard of recklessness under section 20(a) imposes a realistic standard of care that does not unfairly burden controlling persons.

Not only do the 1933 and 1934 Acts regulate different activities, but exposure to secondary liability is far greater under

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161. 1 L. LOSS, *supra* note 1, at 1747. Although §§ 20(a) and 15 are similar in that both provisions hold a controlling person liable, the 1934 Act gives the controlling person a defense that is easier to satisfy. *Id.*

162. Some courts distinguish between bad faith and "mere negligence" by noting that a person can be both negligent and act in good faith. *See, e.g., Sennott v. Rodman & Renshaw*, 474 F.2d 32, 40 n.5 (7th Cir. 1973) (inferring that brokerage firm may have been negligent in failing to discover the fraud, but that firm did not act in bad faith or induce the fraud), *cert. denied*, 414 U.S. 926 (1975).

163. *See supra* note 2.

164. S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 4, Item 17; *see* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 728 (1975) (1934 Act focuses on securities exchanges and over-the-counter market, whereas 1933 Act mandates disclosure of facts regarding securities themselves).

165. For example, during the months of May, June, and July in 1987, there were only 1135 initial offerings. 46 SEC MONTHLY STATISTICAL REV. No. 9, at 17, table M-370 (Sept. 1987). For the same months, 14,752,391,000 shares of stock were traded on the securities exchanges. *Id.* at 9, table M-120.

166. *Id.* at 9, table M-120.

167. *See* *Henricksen v. Henricksen*, 640 F.2d 880, 884-87 (7th Cir.) (stockholder's husband-stockbroker fraudulently mismanaged stock accounts and falsified documents), *cert. denied*, 454 U.S. 1097 (1981); *infra* note 171.

section 20(a) than under section 15 of the 1933 Act.<sup>168</sup> Section 20(a) incorporates the 1934 Act's broad antifraud provision and imposes liability for all varieties of fraudulent conduct practiced by any person in the purchase or sale of a security.<sup>169</sup> Section 15, however, provides a cause of action only for violations of sections 11 and 12 of the 1933 Act, two limited provisions.<sup>170</sup> Although a controlling person could implement a system to ensure against violations of sections 11 and 12 to avoid liability under section 15, a controlling person realistically cannot oversee every transaction regulated by the 1934 Act to escape liability under section 20(a).<sup>171</sup> Unlike section 15's limitation to two liability provisions, section 20(a) potentially encompasses any fraudulent act. Thus, controlling persons should not be required to supervise closely every activity undertaken by a controlled person. Rather, a controlling person should impose and maintain a proper system of supervision, and failure to do so should be considered reckless behavior.<sup>172</sup> If the controlling person, however, willfully induced or in bad faith prevented discovery of the fraud, courts still should impose liability, despite the implementation of a supervisory program.

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168. Section 15 of the 1933 Act applies only to violations of §§ 11 and 12, and only issuers and sellers may be sued under these provisions. 1 A. BROMBERG & L. LOWENFELS, *supra* note 115, § 2.3(100). Additionally, § 15 does not impose liability for violations of the 1933 Act's antifraud provision, § 17(a), which imposes liability for virtually any fraudulent securities transaction. 15 U.S.C. § 77q(a) (1982); *see supra* note 6.

169. Section 10b is the 1934 Act's broad antifraud provision, under which complainants may sue both sellers and buyers for virtually any fraudulent act involving securities. Most litigation under § 20(a) attempting to impose secondary liability involves primary liability under § 10b. 2 A. BROMBERG & L. LOWENFELS, *supra* note 115, § 5.10(430-36). The 1933 Act also has a broad antifraud provision, § 17(a), but a controlling person cannot be sued for violation of this provision. *See supra* note 6. A controlling person may only be sued for violations of §§ 11 and 12. *Id.*

170. *See supra* note 6.

171. Indeed, some transactions occur without the firm ever having any knowledge of the activity. For example, in *Lake v. Kidder, Peabody & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,509 (N.D. Ind. 1973), a plaintiff invested with his broker in a private investment partnership. After substantial losses, the plaintiff attempted to hold Kidder, Peabody liable as a controlling person for § 10b violations. *Id.* at 93,969. The court held Kidder, Peabody could not be liable because the transaction occurred completely outside the normal customer-broker relationship. *Id.* at 93,977-78. Other courts, however, have imposed liability under similar circumstances. *See cases cited supra* note 11; *see also* *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1309 (2d Cir. 1973) (en banc) (noting that Congress anticipated more stringent standard under 1933 Act than under 1934 Act).

172. For courts agreeing that the controlling person must implement a supervisory system, *see infra* note 176.

In addition to substantive differences, the 1934 Act does not contain the same procedural safeguards that the 1933 Act provides to a section 15 defendant.<sup>173</sup> The 1934 Act, unlike the 1933 Act, does not have a statute of limitations,<sup>174</sup> and controlling persons remain subject to potential liability for a longer period of time.<sup>175</sup> That threat alone, without lowering the threshold for asserting claims to a negligence standard, will encourage controlling persons to implement programs of supervision to deter fraudulent conduct.<sup>176</sup> The 1934 Act also does not require a complainant to post a bond nor does it permit assessment of litigation costs when a complainant sues a controlling person.<sup>177</sup> Although the Federal Rules of Civil Procedure bar complainants from asserting frivolous claims under the 1934 Act,<sup>178</sup> the Act lacks the procedural safeguards present in the 1933 Act to deter actions against controlling persons when recovery is unlikely. Thus, requiring a heightened standard of proof such as recklessness<sup>179</sup> protects controlling persons from

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173. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976) (noting that if actions under 1934 Act were based on same negligence standard that §§ 11, 12, and 15 of 1933 Act use, actions would always be brought under 1934 Act, nullifying effectiveness of carefully drawn procedural restrictions under 1933 Act).

174. For example, § 10b, the most frequently litigated provision in the 1934 Act, does not have a statute of limitations. See 15 U.S.C. § 78j (1981). Some courts, however, impose a state limitation period as a matter of federal common law. See, e.g., *Marshall & Ilsley Trust Co. v. Pate*, 819 F.2d 806, 808 (7th Cir. 1987) (applying Wisconsin statute of limitations). State statutes of limitations applied to the 1934 Act, however, are usually longer than the one-year statute of limitations applied to § 15 of the 1933 Act. *Ernst & Ernst*, 425 U.S. at 210 n.29.

175. See *Herm v. Stafford*, 663 F.2d 669, 679, 684 (6th Cir. 1981) (because plaintiff filed complaint so long after alleged fraud, controlling person was held liable under § 20(a) of 1934 Act but not liable under § 15 of 1933 Act).

176. Many courts agree that a controlling person should be required to maintain and enforce a system of supervision because of the "ever-present" opportunity and temptation to defraud investors. See, e.g., *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 213 (D. Mass. 1978); accord *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1120 (5th Cir. 1980) (failure to supervise is evidence of bad faith); *Lorenz v. Watson*, 258 F. Supp. 724, 732 (E.D. Pa. 1966) (to satisfy good faith requirement, defendants must show that some precautionary measures were taken to prevent injury suffered by investor).

177. Section 10b, which is the most frequently utilized provision in actions brought under the 1934 Act, provides no statute of limitations, and the court's authorization to award attorney's fees under this section is sharply circumscribed. *Ernst & Ernst*, 425 U.S. at 210.

178. FED. R. CIV. P. 11.

179. The Supreme Court has acknowledged that recklessness can be a mental state embracing intent to deceive, manipulate, or defraud. *Ernst &*

having to defend nonmeritorious, harassing claims for secondary liability, while providing investors with adequate protection from fraud.

### CONCLUSION

The 1933 and 1934 Acts hold a controlling person jointly and severally liable for the fraudulent acts of a controlled person. Congress declined to define a controlling person, delegating to courts the task of determining the proper standard of liability based on the specific facts of each case. Without Congress's guidance, however, federal courts have failed to devise uniform standards to decide when a person is secondarily liable as a controlling person. This failure has resulted primarily from attempts to construe both statutes' controlling person provisions as requiring identical standards.

To rectify the difficulty of defining a uniform standard, courts should recognize that the substantial differences in the purposes of the two Acts and in the language of their controlling person provisions compels the use of different liability

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*Ernst*, 425 U.S. at 193 n.12. The Court, however, has expressly declined to hold that recklessness would always suffice as scienter under the 1934 Act. *Id.* The majority of circuits, acknowledging the Supreme Court's dicta, hold that recklessness is a sufficiently culpable state of mind to satisfy a standard equivalent to scienter or bad faith. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979) (recklessness satisfies scienter requirement); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.) (per curiam) (recklessness satisfies bad faith requirement), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 44-45 (2d Cir.) (recklessness is knowing conduct and satisfies bad faith standard), *cert. denied*, 439 U.S. 1039 (1978); *Coleco Indus. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) (per curiam) (recklessness is similar to conscious intent to defraud), *cert. denied*, 439 U.S. 830 (1978); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977) (recklessness satisfies scienter requirement), *cert. denied*, 435 U.S. 952 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-40 (7th Cir.) (recklessness is form of intentional fraudulent conduct), *cert. denied*, 434 U.S. 875 (1977).

In another context, the Supreme Court has held that recklessness suffices to meet a subjective bad faith standard. In a defamation action to overcome a first amendment privilege given to a person speaking about public figures, the plaintiff must prove that the defendant acted with actual malice. The Court has defined "actual malice" to mean "with knowledge that [the statement] was false or with reckless disregard of whether it was false or not." *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964).

Additionally, many commentators agree that recklessness should suffice to meet a bad faith standard. See, e.g., Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 239 (1977) (recklessness sufficient to satisfy scienter requirement); Note, *supra* note 29, at 839-43 (proper standard under § 20(a) of 1934 Act is recklessness). For the definition of recklessness, see *supra* note 144.

standards under each Act. Under both Acts courts should continue to require the complainant to prove that the defendant was a controlling person. To defeat liability, however, courts should require the controlling person to prove nonnegligent conduct under the 1933 Act. A negligence standard not only complies with the reasonableness language of the 1933 Act's controlling person provision, but also conforms with the Act's requirement of greater protection for investors. Under the 1934 Act, in contrast, courts should require controlling persons to show that their actions were merely not reckless. The lesser standard under this Act is justified by the Act's good faith defense as well as its broad coverage of brokerage activity. Separate liability standards under each Act will not only remove the confusion surrounding judicial attempts to create a uniform standard, but will also further Congress's intent to restore confidence in the securities markets and deter securities fraud.

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