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## THE CONTROLLING PERSONS PROVISIONS: CONDUITS OF SECONDARY LIABILITY UNDER FEDERAL SECURITIES LAW

### I. INTRODUCTION

Section 15 of the Securities Act of 1933<sup>1</sup> (1933 Act) and section 20(a) of the Securities Exchange Act of 1934<sup>2</sup> (1934 Act) impose joint and several liability upon controlling persons for the securities law violations of controlled persons.<sup>3</sup> Liability may flow under these sections even though the controlling person was neither a participant in, an aider and abettor of, nor a conspirator with respect to the conduct constituting the primary violation of the securities acts.<sup>4</sup>

The term "control" encompasses a relationship broader than that of principle and agent.<sup>5</sup> Yet, the sections do not impose an insurer's liability

1. 15 U.S.C. § 77o (1970). Section 15 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.

*Id.*

2. 15 U.S.C. § 78t(a) (1970). Section 20(a) provides:

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

*Id.*

3. Section 15 of the 1933 Act applies only where the controlled person has violated section 11 of the 1933 Act, 15 U.S.C. § 778 (1970), or section 12 of the 1933 Act, 15 U.S.C. § 771 (1970). Therefore, controlling persons liability would not appear to extend to violations of section 17(a) of the 1933 Act, 15 U.S.C. § 77g(a) (1970), should an implied private right of action for damages be recognized under that provision. For a discussion of section 17(a) and the question of an implied private right of action, see Note, *Implied Civil Remedies Under Section 17(a) of the Securities Act of 1933*, 53 B.U.L. REV. 70 (1973).

Section 20(a), on the other hand, extends controlling persons liability to violations of any provision of the 1934 Act by a controlled person.

4. The common law concepts of aiding and abetting and conspiracy have been imported into the federal securities law as means of imposing secondary liability upon persons who have not themselves directly engaged in conduct which violates a statutory prohibition, but who are somehow responsible for such a violation. A person is an aider and abettor of a primary wrongdoer if he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . ." RESTATEMENT OF TORTS, § 876 (1939). See *Brennan v. Midwestern Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970). A person is liable as a conspirator for another's violation of the securities law, if he has agreed to a plan to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means, and if the primary violation is committed in furtherance of that plan. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 636 (1972).

5. A controversy exists concerning whether the controlling persons sections are exclusive, i.e., whether they supersede agency and other means of imposing vicarious liability upon principals for the securities law violations of their agents.

upon controlling persons; each provides a special defense.<sup>6</sup> Under section 15, a controlling person who establishes that he "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" is not liable for the controlled person's violation.<sup>7</sup> Similarly, section 20(a) affords a controlling person the affirmative defense that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."<sup>8</sup>

Although the controlling persons provisions are phrased in language which renders them capable of application in a wide variety of circumstances, the courts have applied them most frequently to determine: (1) the liability of broker-dealers for violations by their employees, correspondents, and other controlled persons; (2) the liability of corporation-issuers for violations by their employees and other controlled persons; and (3) the liability of directors for violations by agents of the corporation. Accordingly, the focus of this Comment will be upon the use of these provisions in these three broad areas.<sup>9</sup>

## II. LEGISLATIVE HISTORY OF THE CONTROLLING PERSONS PROVISIONS

### A. Section 15 of the 1933 Act

Section 15 of the 1933 Act originated in the "dummy" provisions contained in the original Senate draft of the Act.<sup>10</sup> The purpose of those draft provisions appears to have been to prevent persons who controlled a cor-

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If they are held exclusive, a principal who is also a controlling person of his agent may interpose the special defense contained in sections 15 and 20(a), which are unavailable under agency theory. For a more complete discussion of the exclusivity problems, see notes 33-41 and accompanying text *infra*.

6. Where liability is asserted to exist under one of the controlling persons provisions, the burden is upon the plaintiff to make a prima facie showing that the defendant controlled the primary wrongdoer. *Gordon v. Burr*, 366 F. Supp. 156, 170 (S.D.N.Y. 1973). The burden of establishing that he comes within the special defenses then rests on the defendant. *Id.* at 166 n.11. Similarly, it should be noted that it is necessary to establish that a primary violation has been committed by the controlled person in order for liability to flow to a controlling person. In *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680 (5th Cir. 1971), defendants were sued as controlling persons of sellers who had violated section 12(2) of the 1933 Act by making false statements in connection with the sale of securities. The controlled persons, however, did not know such statements were false and were therefore not liable under section 12(2). The court stated that the controlling persons were not liable under section 15 despite their knowledge of the falsity of the representations made by the controlled persons because a primary violation had not been established. *Id.* at 696. It is, however, unnecessary to sue a primary wrongdoer, provided his violation is established, in order to impose liability upon a controlling person. *DeMarco v. Edens*, 390 F.2d 836, 840 (2d Cir. 1968).

7. 15 U.S.C. § 77o (1970).

8. 15 U.S.C. § 78t(a) (1970).

9. The controlling persons provisions, of course, have a broad potential for application in areas beyond those discussed in this Comment. See, e.g., *Ayers v. Wolfenbarger*, 491 F.2d 8, 14-15 (1974), for a discussion of the question of whether a seller who retains a security interest in shares sold under an installment contract is a controlling person of the vendee with respect to those shares.

10. S. 1273, 73d Cong., 1st Sess. § 32(k), 4, 13 (1933).

poration from evading liability for securities law violations where they exercised their power through dummy directors. The Senate draft provided, in part, that a "dummy" was "a person who [had] nominal power or authority to act in any capacity but [was] under moral or legal obligation to act therein in accordance with the direction of another,"<sup>11</sup> and made it unlawful to employ a "dummy" "with the intent to defraud."<sup>12</sup> The scope of these draft provisions was thus fairly narrow. The relationship contemplated was one in which one party truly dominated another, and liability would flow only where the use of a "dummy" was "resorted to with fraudulent intent."<sup>13</sup>

The "dummy" provisions of the Senate draft were incorporated in the provision finally enacted. The original section 15 of the 1933 Act provided:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.<sup>14</sup>

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11. S. 875, 73d Cong., 1st Sess. § 2(k) (1933). This provision provided in full: "Dummy" shall mean a person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligations to act therein in accordance with the direction of another.

*Id.*

12. S. 875, 73d Cong., 1st Sess. § 13 (1933). This section provided in part: It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly, in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities willfully to employ any device, scheme, or artifice or to employ any "dummy", or to act as any such "dummy", with the intent to defraud or obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice, or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser. The director or other person for whom any "dummy" shall act shall be held responsible under this act for any unlawful conduct by such "dummy": *Provided*, That the said "dummy" shall not be deemed discharged from any liability for any unlawful conduct under this act. It shall be unlawful for any person who is a "dummy" for another to sign a registration statement without disclosing his principal or principals.

*Id.*

13. S. REP. NO. 47, 73d Cong., 1st Sess. 6 (1933). The report contained these additional comments concerning the "dummy" provisions:

In order to aid in preventing directors from evading the liabilities incident to signing the registration statement, there are provisions governing "dummy" directors . . . . The bill does not attempt to declare the use of "dummy" directors unlawful except where such use is resorted to with fraudulent intent. It requires the disclosure of the character of such directors as dummies and for whom they act. It necessitates the execution of the registration statement by the real, as well as the dummy, director unless excused by the Commission for good cause. . . . The committee believes that this phase of the law will tend to do away with the present dangerous and unreliable system of depending upon dummy directors who have no responsibility.

*Id.*

14. Act of May 27, 1933, ch. 38, § 15, 48 Stat. 84.

This provision, which lacked the special defense contained in the present section 15, was apparently intended to have the same effect as the "dummy" provisions contained in the Senate draft.<sup>15</sup>

In 1934, the Securities Act was amended in response to criticisms that it was "too drastic, and [was] interfering with business."<sup>16</sup> Two amendments were offered to section 15, which were intended not so much to change its effect as to clarify its original purpose. Senator Hastings proposed one amendment, which provided:

Every person who by or through stock ownership or agency, or who, pursuant to an agreement with one or more other persons by or through stock ownership or agency, controls any person, and who for the purpose of evading liability under section 11 or section 12 causes such controlled person to take any action which renders such controlled person liable under section 11 or section 12 shall be subject to liability under section 11 or section 12 to the same extent as if such controlling person had taken such action directly.<sup>17</sup>

Federal Trade Commissioner Landis, who had participated in the drafting of the original act, feared that the language of the Hastings amendment might be so interpreted as to totally eviscerate the section, but sympathized with the desire to clearly limit the application of section 15 to those situations in which "dummies" were used in order to evade liability.<sup>18</sup>

The second amendment, offered by Senator Fletcher, proposed the addition of the following language at the end of the original provision:

Unless the act for which such controlled person is alleged to be liable under section 11 or 12 was not performed at the direction of the controlling person nor to enable such controlling person to evade liability under said sections.<sup>19</sup>

Senator Fletcher explained that the amendment was intended "to restrict the scope of the section so as more accurately to carry out its real purpose. The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based."<sup>20</sup>

It was therefore with the intention of limiting the application of section 15 to those situations where a controlling person had effectively exercised

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15. The House Report states:

The Senate amendment contained provisions referred to as "dummy provisions" which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other. The House bill did not contain these provisions. The various provisions of the Senate amendment on this subject have been welded into one and incorporated as a new section in the substitute.

H.R. REP. NO. 152, 73d CONG., 1st Sess. 27 (1933).

16. 78 CONG. REC. 8668 (1934) (remarks of Senator Fletcher).

17. S. 3301, 73d CONG., 2d Sess. § 7 (1934).

18. Letter from Commissioner Landis to Senator Fletcher, May 2, 1934, in 78 CONG. REC. 8714, 8717 (1934).

19. CONG. REC. 8668 (1934) (proposed amendment of Senator Fletcher).

20. *Id.* at 8669 (memorandum explanatory of suggested amendments).

his control to bring about the violation that Congress amended the section in 1934, adding the special defense which it now contains.<sup>21</sup> A controlling person is thus not liable if he had "no knowledge of or reason to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."<sup>22</sup>

### B. Section 20 of the 1934 Act

In 1934 Congress also enacted the Securities Exchange Act<sup>23</sup> which contained a controlling persons provision, section 20(a), similar in effect to section 15. The special defense contained in section 20(a) exonerates a controlling person if he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."<sup>24</sup> In this section, as in section 15, the term "control" is not defined, an omission which the House Report indicates was deliberate.<sup>25</sup>

In the Congressional debates which preceded the enactment of the 1934 Act, Representative Hollister suggested striking the controlling persons section. He feared that, because of the vagueness of the term "controlling persons," honest men would be subjected to strike suits simply because they were somehow connected with a corporation which had violated the act.<sup>26</sup> In response to his concern, Representative Lea stated that the

21. See Act of June 6, 1934, ch. 404, § 208, 48 Stat. 908, *amending*, Securities Act of 1933 § 15, ch. 38, § 15, 48 Stat. 84.

22. 15 U.S.C. § 77o (1970).

23. 15 U.S.C. § 78 (1970).

24. 15 U.S.C. § 78t(a) (1970).

25. The Report states:

In this section and in section 11, when reference is made to "control", the term is intended to include actual control as well as what has been called legally enforceable control. (*See Handy & Harmon v. Burnet* (1931) 284 U.S. 136.) It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934).

In *Handy & Harman v. Burnet*, 284 U.S. 136 (1931), cited in the report as an example of actual control, an issue was whether the six majority shareholders of a corporation "controlled" the stock owned by the president of that corporation within the meaning of that term as used in § 240(b)(2) of the Revenue Act of 1918, ch. 18, § 240(b)(2), 40 Stat. 1082. The six owned 75% of the stock; the president owned 20%. The president had pledged his stock to one of the six as security for a loan and had never voted in opposition to the majority shareholders. The Court held that the six did not have legally enforceable control of the president's stock such as was required under the Revenue Act, but did note that the majority shareholders did exert actual control over the president:

[s]hareholders . . . , through their power over [the president's] official position and salary, their ability to dominate both corporations or by other means, were in a position effectually to influence him in respect of the voting, use or disposition of the stock issued to him, and thus as a practical matter to exert a kind of control called by counsel "actual" to distinguish it from a legally enforceable control.

scope of the provision was more narrow than envisioned by Representative Hollister — it was intended only to “catch the man who stands behind the scenes and controls the man who is in a nominal position of authority.”<sup>27</sup> He added that “[t]he man charged with control is only responsible to the extent he did control the action complained of, and his actual control must be established.”<sup>28</sup> When asked by Representative Hollister to further define “control”, Representative Lea stated, “[i]t is simply a question of putting the responsibility on the man who is really responsible.”<sup>29</sup> To establish an individual’s liability as a controlling person, then, it would be necessary “to show that one man did control the other in doing a wrongful thing . . . .”<sup>30</sup> That definition, of course, fails to clarify the meaning of control because it merely defines the word in terms of itself.

### C. Summary

The absence of a definition of control is the most serious flaw in the controlling persons provisions.<sup>31</sup> While the legislative history of the sections does not reveal any expression of intent regarding the criteria of control, it is clear that their enactment was motivated by a fear that traditional theories of secondary liability, such as agency, would not prove adequate, in every case, to extend liability to those who were “really responsible” for violations of the securities laws. Unfortunately, the provisions, drafted in broad and somewhat amorphous language, have at times proved to be unwieldy instruments for making the fine discriminations necessary in developing standards of responsibility in the securities law area.

## III. CASE LAW UNDER SECTIONS 15 AND 20.

### A. Liability of Broker-Dealer Firms As Controlling Persons

#### 1. Liability for Violations of Securities Laws by Employees

The courts have generally assumed that a broker-dealer is a controlling person of its employee salesman and officers.<sup>32</sup> One controversy that has arisen in this context is whether sections 15 and 20 are the exclusive

27. *Id.* at 8095 (remarks of Representative Lea).

28. *Id.*

29. *Id.*

30. *Id.*

31. It should be noted that control is defined by SEC regulations for other purposes of the securities acts. For example, the following definition is applicable to the requirements relating to registration statements under section 5 of the 1933 Act, 15 U.S.C. § 77e (1970):

The term “control” (including the terms “controlling,” “controlled by” and “under common control with”) means 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(f) (1973).

32. See, e.g. SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970); Kamen & Co. v. Paul Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. granted*, 390 U.S. 942 (1968), *cert. dismissed*, 393 U.S. 801 (1969); Gordon v. Burr, 366 F. Supp. 156 (S.D.N.Y. 1974); SEC v. [redacted]’s, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973); Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966).

means of imposing liability upon controlling persons, or whether the special defenses provided by the sections may be circumvented, where appropriate, by the use of principles of agency or respondeat superior.<sup>33</sup> Under the theory of respondeat superior, once it is established that an employee's wrongful act was committed within the scope of his employment, liability flows automatically to the employer. In contrast to the controlling persons sections, the employer's own lack of fault is irrelevant.<sup>34</sup>

Advocates of the position that the controlling persons provisions are nonexclusive contend that sections 15 and 20 were not intended to limit liability, but were intended to create a liability that would supplement and extend beyond common law principles of agency and respondeat superior.<sup>35</sup> One court has stated, "a contrary conclusion would in effect give blessing to a hear-no-evil, see-no-evil approach by partners of a brokerage house which is hardly in keeping with the remedial purposes of the '33 Act . . ."<sup>36</sup> In addition, the Securities Exchange Commission (SEC) has claimed that the availability of a standard of absolute liability "would greatly enhance [its] capability for policing the exchanges and for deterring violations of the rules."<sup>37</sup>

The express language of section 15, however, lends support to the proposition that Congress intended to supplant agency theory as a means of imposing vicarious liability for securities law violations when it enacted the controlling persons provisions. Section 15 is expressly applicable to "[e]very person who, by or through stock ownership, *agency or otherwise* . . . controls any person liable under sections [11] or [12] . . ."<sup>38</sup> Similarly, section 20 applies to "[e]very person who, *directly* or indirectly, controls any person liable" under the provisions of the 1934 Act.<sup>39</sup> Moreover, a literal reading and application of these sections would not necessarily impair the regulatory functions of the securities laws since many courts have required broker-dealers to show that they have supervised their employees in an adequate and reasonable fashion, a duty which has been stringently defined, in order to sustain the special defenses contained therein.<sup>40</sup> As one court stated, "[I]t would seem that the regulatory goals

33. Compare *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1061-64 (S.D.N.Y. 1973) (the controlling persons sections are exclusive) with *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1211-12 (D. Md. 1968), *aff'd on this point*, 422 F.2d 1124, 1130 (4th Cir. 1970) (the controlling persons sections are not exclusive).

34. See *Lewis v. Walston & Co.*, 487 F.2d 617 (5th Cir. 1973). In *Lewis* a brokerage firm was held liable for the violation of section 12(1) of the 1933 Act, 15 U.S.C. § 77e(1) (1970), by an employee representative on the basis of agency principles without a discussion of the exclusivity problem under section 15. *Id.* at 623-24.

35. See *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1211-12 (D. Md. 1968), *aff'd on this point*, 422 F.2d 1124, 1130 (4th Cir. 1970).

36. *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968).

37. *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1062 (S.D.N.Y. 1973).

38. 15 U.S.C. § 77o (1970) (emphasis added).

39. 15 U.S.C. § 78t(a) (1970) (emphasis added). The House Report enumerates

39. See *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968), *aff'd on this point*, 422 F.2d 1124, 1130 (4th Cir. 1970).

40. See, e.g., *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1064 (S.D.N.Y. 1973).



of the Commission could be at least substantially achieved by the enforcement of this duty, rather than by the attempt to read a non-existent insurer's liability into the statute for broker-dealers."<sup>41</sup>

In order for a broker-dealer to sustain a defense of "good faith" under section 20(a) with respect to a violation committed by one of its employees or officers, it must demonstrate that it maintained an adequate and reasonable system for the internal control and supervision of its employer-salesmen. This affirmative duty is unique to the broker-dealer controlling person, and may not be warranted by the statutory language. In nearly all other areas, controlling persons have been considered to have met the burden of proving the good faith defense through a showing that they acted without knowledge of the wrongful conduct of the controlled person.<sup>42</sup>

The broker-dealer's affirmative duty was first imposed in *Lorenz v. Watson*,<sup>43</sup> in the context of a decision denying summary judgment to a broker-dealer defendant. The complaint alleged that Watson, an employee of the defendant Bioren & Company, had defrauded the plaintiffs by churning their account in violation of rule 10b-5.<sup>44</sup> Bioren was alleged to be liable for Watson's fraud under section 20(a) because it had failed to properly supervise his activities and to investigate his background prior to employing him. Bioren asserted that the complaint failed to state a claim under section 20 because it did not allege that the firm had induced Watson's violation. The court rejected that assertion, noting that the defendants were required to show "good faith" by demonstrating that "some precautionary measures were taken to prevent the injury suffered" in order to escape liability as a controlling person.<sup>45</sup> The court stated:

[C]onsiderable injury to the investing public is not only possible but inevitable when a salesman is compensated in direct proportion to the volume of transactions he handles, and his activities go unsupervised. The most effective means for insuring adequate supervision is to impose liability for injury resulting from its absence.<sup>46</sup>

In *Hecht v. Harris, Upham & Co.*,<sup>47</sup> another case involving the churning of a customer account by a representative of a broker-dealer, the district court held that the defendant brokerage firm had failed to meet its burden of proving "good faith" under section 20(a) in two respects. First, the defendant had failed to maintain a reasonably adequate system of internal control and supervision. Second, the defendant had not enforced whatever

41. *Id.*

42. See text accompanying notes 74, 87 *infra*.

43. 258 F. Supp. 724 (E.D. Pa. 1966).

44. Churning is excessive trading, disproportionate to the size and character of an account, carried on primarily to generate commissions rather than to benefit a customer. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 431 (N.D. Cal. 1968), *aff'd as modified*, 430 F.2d 1202 (9th Cir. 1970).

45. 258 F.2d at 732.

46. *Id.* at 733.

47. 283 F. Supp. 417 (N.D. Cal. 1968) *aff'd as modified*, 430 F.2d 1202 (9th Cir.

system it had maintained with any diligence.<sup>48</sup> The court derived the standards by which it evaluated the Harris, Upham system from publications of the American Association of Stock Exchange Firms and the National Association of Securities Dealers (NASD).<sup>49</sup>

In *SEC v. First Securities Co.*,<sup>50</sup> the court derived the standard of adequate supervision from the NASD Rules of Fair Practice. The president of First Securities misappropriated the funds of several customers, telling them that their funds had been deposited in an "escrow" account. The fraud had been facilitated by a rule which forbade anyone at the company from opening or reading correspondence addressed to the president. The court held that by permitting the president's correspondence to go unmonitored, the firm had failed in its duty of diligent supervision.<sup>51</sup> Rule 27 of the NASD Rules of Fair Practice provided, in pertinent part:

Each member shall review . . . all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.<sup>52</sup>

*SEC v. Lum's, Inc.*,<sup>53</sup> on the other hand, presents a case in which the court held that defendant, Lehman Brothers, a brokerage firm, had complied with its duty "to supervise its employees in an adequate and reasonable fashion" and thus had sustained its burden of "good faith" under section 20(a) with respect to a violation of rule 10b-5 by one of its employees, Simon. Simon had obtained inside information from Lum's con-

48. 283 F. Supp. at 439.

Harris, Upham rules stated that all commodity accounts for women were unacceptable unless approved by a partner who determined the woman involved had "sufficient experience and knowledge of commodity trading." The rules also required that a partner approve specific commodity transactions for a woman's account. *Id.* at 438. The partner required to approve the opening of the plaintiff's commodity account made no inquiry concerning the trading experience of the plaintiff, an elderly widow, and, even though the account was one of the most actively traded and lucrative (in terms of commissions) at the firm's San Francisco office, no further inquiries were made. The court therefore held that Harris, Upham had not sustained its burden of showing that it acted in "good faith." *Id.* at 439.

49. *Id.* at 438. The court stated:

These publications indicate that good standard practice in the brokerage business requires that a "partner" is obliged to know the "essential facts" relative to each customer and to "supervise diligently" all accounts handled by registered representatives to obtain the appropriate facts concerning each customer prior to opening the account; that each time a new account is opened new information should be obtained directly from the customer; that the investigation performed by the registered representative should be a continuing one; that note of any changes in the customer's financial status should be kept, that the registered representative should ascertain whether the customer understands the basic mechanics of purchasing securities, that representatives must know and keep themselves informed of circumstances relating to their clients' interests which may have a bearing on the clients' interests as investors, and that a firm should not rely exclusively on a registered representative to obtain the essential facts but should have a series of checks to determine that the full facts, are being obtained sufficiently to satisfy the firm's responsibilities.

*Id.*

50. 463 F.2d 981 (7th Cir. 1972).

51. *Id.* at 987.

52. *Id.* at 988, quoting Rule 27, National Association of Securities Dealers Rules of Fair Practice.

53. 365 F.2d 1046 (S.D.N.Y. 1966).

cerning an unanticipated contraction of earnings. He passed the information on to two of his institutional customers who then sold their Lum's stock before the news became public. The SEC contended that Lehman Brothers had breached its duty to supervise its salesmen by permitting Simon to maintain close contacts with Lum's while his clients held large quantities of Lum's stock. Lehman had no rules relating to contacts of salesmen with issuers. The SEC maintained that Lehman should have been aware of the danger that inside information might be volunteered to Simon and perhaps be inadvertently forwarded. The court held that Lehman Brothers had maintained an adequate system of supervision.<sup>54</sup> Reviewing the evidence which had been presented on the issue, the court noted:

Lehman established at trial through several witnesses that it maintained at the time a compliance department, staffed by several competent and experienced attorneys, whose responsibility it was to maintain a comprehensive supervisory system for the entire organization. In this regard, compliance personnel would periodically visit the offices of Lehman and meet the salesmen to discuss problems of dealing with inside information and other matters. In addition, memoranda were regularly circulated to keep all personnel current on new developments in the field. Lehman also distributed to all of its branch offices a book of guidelines or supervisory procedures . . . as well as a video tape concerning Rule 10b-5 problems. [A partner] testified that, in sum, the firm was insistent that the entire sales and distribution organization be kept apprised of the securities acts and the means of compliance therewith.<sup>55</sup>

#### a. Summary

The broker-dealer cases involving liability for acts of employees, demonstrate the unwieldiness of the controlling persons provisions as instruments for imposing liability on those really responsible for securities law violations. The legislative history indicates that the drafters intended to expand the scope of secondary liability for such violations, yet a straightforward reading of the statutory language compels the conclusion that these provisions have replaced, rather than merely supplemented, agency theory as a vehicle of liability. As a result, the scope of liability has been nar-

54. *Id.* at 1065.

55. *Id.* at 1064-65.

In *Gordon v. Burr*, 366 F. Supp. 156 (S.D.N.Y. 1973), the court held that a broker-dealer had failed to sustain its burden of showing good faith under section 20(a). The court indicated that a demonstration similar to that concerning Lehman Brother's system of supervision in *S.E.C. v. Lum's*, would be required in order to avoid liability. *Id.* at 169.

Section 15(b)(5)(E) of the 1934 Act, 15 U.S.C. § 78o(b)(5)(E) (1970), permits the Securities and Exchange Commissioner to revoke or suspend the registration of a broker-dealer which has failed to adequately supervise its representatives with a view to preventing violations of the securities acts. In *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), the court held that a broker-dealer who had failed to meet the standard of adequate supervision in section 15(b) might be directly liable to a purchaser injured by the fraudulent conduct of its employee. *Id.* at 445. For an administrative construction of this provision, see *F.S. Johns & Co., Securities Exchange Act Release No. 792* (Oct. 10, 1966).

rowed in some cases. Persons who heretofore would have been strictly liable under theories of agency are, under these provisions, afforded a defense of good faith. On the other hand, rather than narrowing the scope of liability, some courts have disregarded the statutory language and have continued to apply principles of agency in evaluating the liability of broker-dealers for the acts of their employees. Others have sought to mitigate the effect of the statutory language by watering down the good faith defense and have imposed upon broker-dealers an affirmative duty to take precautionary measures to prevent employee violations. While the imposition of such a duty seems consistent with the broad purpose of the securities laws — to protect the investing public — it is not warranted by the statutory language.

## 2. *Liability for Violations of Securities Laws by Correspondent Brokers*

The use of the controlling persons provisions to extend liability to broker-dealers for violations committed by correspondent brokers illustrates how these sections have been used to expand the scope of secondary liability beyond the limits imposed by agency principles. A broker who is not a member of a stock exchange on which he wishes to execute an order must employ a member broker to execute the trade. In such a transaction, the member broker is called the carrying broker; the other is called the correspondent<sup>56</sup> and it is usual that a continuing relationship develops between them. Customarily, the carrying broker furnishes the correspondent with a teletype wire connection to facilitate such transactions.<sup>57</sup> Absent special facts, the correspondent is not considered to be an agent of the carrying broker. Consequently, the carrying broker is not subject to vicarious liability to customers of the correspondent for defalcations by the correspondent in the transactions.<sup>58</sup>

In *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*,<sup>59</sup> however, a carrying broker was held liable to defrauded customers of a correspondent under Section 20(a). Waddy, the correspondent, had defrauded customers by keeping funds which they had given him for the purchase of stock through Merrill Lynch, and also had secretly and wrongfully sold securities which had been so purchased — keeping the proceeds for himself. The fraud had been facilitated by Waddy's use of an omnibus account in which the funds and securities of several customers were intermingled so that any unauthorized transactions would be difficult to detect.<sup>60</sup> An SEC regulation required brokers to file certified financial statements for such omnibus accounts except where the account was used to hold securities on

56. See *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 108 (W.D. Ark. 1949); C. MEYER, *THE LAW OF STOCKBROKERS AND STOCK EXCHANGES* § 124 (1931).

57. See *Smith v. Bear*, 237 F.2d 79, 82 (2d Cir. 1956).

58. See *Krstovic v. Ban Buren*, 235 N.Y. 96, 101, 138 N.E. 749, 751 (1923); MEYER, *supra* note 56 at § 124.

59. 85 F. Supp. 104 (W.D. Ark. 1949).

60. *Id.* at 124.

a short-term basis as an incident to transactions in which securities were promptly delivered to customers.<sup>61</sup> Although Merrill Lynch was aware that Waddy had been holding securities in the account on a long-term basis and that he had been transacting a large volume of business in the account, it aided him in avoiding the SEC filing requirement.<sup>62</sup> The court found that had a certified accounting been carried out, the losses might have been prevented.<sup>63</sup>

The defrauded customers sought to hold Merrill Lynch liable for Waddy's fraud. A contention that Merrill Lynch was liable on agency principles for the fraud was rejected on the basis of the general rule that a correspondent is not considered an agent of a carrying broker.<sup>64</sup> The court did find, nevertheless, that Merrill Lynch had engaged in a course of conduct rendering it directly liable to the plaintiffs under Rule 10b-5, and also found that Merrill Lynch was secondarily liable under Section 20(a) for Waddy's misconduct.<sup>65</sup> The court did not presume the existence of control simply from the correspondent relationship, but listed the specific factors which it considered to demonstrate control:

[The] defendants directed Waddy in the conduct of his business by furnishing him the wire, the cotton ticker, prescribing the form of accounts, prescribing the manner in which accounts, both segregated and [omnibus], were to be handled, furnished part of the forms for the transaction of his business, checked and approved his confirmation forms, made available the services of their research department to him and his customers, furnished market news and various publications pertaining to various industries, and particularly directed him in his compliance with the rules of the exchanges and through dictation of his replies to the S.E.C. enabled him to continue the use of [the omnibus account] to the injury of plaintiffs.<sup>66</sup>

The court, however, did not set forth a test of control; it appeared satisfied that the facts demonstrated that control existed. By aiding Waddy to avoid the SEC filing requirement, Merrill Lynch was held by the court to have induced the violation; therefore liability was held to ensue under Section 20(a).<sup>67</sup>

In *Smith v. Bear*,<sup>68</sup> the court held that partners in the brokerage firm of Bear, Stearns & Co., though controlling persons, were not liable for the fraud of one Livingstone, president of its wire correspondent Livingstone & Co. The evidence relevant to control was that Livingstone was a close friend of several of the Bear, Stearns partners; two-thirds of Livingstone & Co.'s capital had been provided by wives and relatives of the partners;

61. SEC Rule X-17A-5, as amended, 17 C.F.R. § 240.17a-5 (1973).

62. 85 F. Supp. at 114, 124.

63. *Id.* at 120.

64. *Id.*

65. *Id.* at 123.

66. *Id.*

67. *Id.* at 123-24.

68. 237 F.2d 79 (2d Cir. 1956).

and Bear, Stearns maintained and paid for the wire to Livingstone. On the other hand, neither the partners of Bear, Stearns, nor their wives and relatives had ever interfered with the management of Livingstone.<sup>69</sup> The court affirmed a jury finding that Bear, Stearns "controlled" Livingstone & Co. within the meaning of Section 20(a), but held that they had acted in good faith and had not induced Livingstone's violation.<sup>70</sup>

### a. Summary

The cases indicate that control will not be presumed from the correspondent relationship per se, but that its existence must be based upon an evaluation of the facts peculiar to each case. Such an approach appears appropriate under the controlling persons provisions. However, it also appears that the correspondent relationship itself should generate certain responsibilities owed by the carrying broker to customers of its correspondent. The development of general standards of liability to govern the correspondent relationship would contribute to broad purposes of the securities acts by providing further protection of the investing public. Therefore, a specific statutory provision, the application of which is not contingent upon a finding of control, ought to be enacted to govern liability in this area.

It should be noted that *Smith v. Bear*, in contrast to the cases relating to liability of brokers for employee violations, the defendant carrying broker was not required to demonstrate that it had taken affirmative precautionary measures to prevent the violation of its correspondent to satisfy the good faith defense. Lack of notice was held adequate.<sup>71</sup> This less rigorous construction of good faith, as well as being more consistent with the meaning commonly ascribed to the term, also appears consistent with the goal of fixing liability according to responsibility. A broker should not be expected to exercise the same degree of supervision over independent correspondents as it should over its own employees.

### 3. Other Extensions of the Scope of Liability Under the Controlling Persons Provisions

Broker-dealers may also be subject to liability as controlling persons for violations of persons with whom they have no formal relationship. Two cases illustrate the possible sweep of controlling persons liability in this respect and emphasize the need to develop criteria which will serve to limit and define the scope of potential liability under the sections.

In *Anderson v. Francis I. DuPont*,<sup>72</sup> customers of an unlicensed and unregistered broker, Hinch, claimed that the DuPont and Ritten brokerage

69. *Id.* at 82.

70. *Id.* at 88.

71. *Id.*

72. 291 F. Supp. 705 (D. Minn. 1968).

firms were liable as controlling persons for the unregistered broker's fraud. There was evidence that the firms had permitted Hinch to use their office and telephone facilities, had permitted him to engage in extensive trading, had allowed him to duplicate various market materials, and had allowed him to bring visitors to their offices. The court held that evidence sufficient to withstand a motion for summary judgment for the defendant firms on the issue of control.<sup>73</sup> While the evidence may have raised a triable issue of fact, further evidence demonstrating direction or influence of Hinch's activities by the defendants would appear to have been necessary to support a conclusion that the firms controlled him.

In *Sennott v. Rodman & Renshaw*,<sup>74</sup> the Seventh Circuit sought to limit the scope of controlling persons liability, and held a broker-dealer not subject to controlling persons liability in a situation in which the defrauded plaintiff did not believe that the broker was involved and the broker was in fact not involved in the subject securities transaction. Jordan Rothbart, a former Rodman employee, had engaged in a series of non-fraudulent transactions with the plaintiff and had used Rodman's facilities to effect them. Rothbart's father, a partner in Rodman, had also been involved in those transactions. In the transaction which gave rise to the cause of action, Rothbart offered to sell securities to the plaintiff at a bargain price under an option he claimed to have personally obtained. The plaintiff did not believe that the Rodman firm was involved, and thought that the shares would come directly from the issuer. The court held that controlling persons liability would not lie under the circumstances:

Similarly, plaintiffs' theory and the trial court's finding that Rodman is liable under Section 20(a) of the Securities Exchange Act of 1934 . . . as a "controlling person" over . . . Jordan Rothbart [and his father] is without merit. The trial judge found that Rodman was in a position to control both men and that the partnership 'did not act in good faith in exercising such control.' That finding while sufficient to impose liability on Rodman for any of the pre-option scheme stock solicitations in which [the plaintiff] actually relied upon Rodman's involvement in deciding whether to act, is not an adequate foundation upon which to base liability where Rodman was admittedly not considered to be involved in the transaction. Rodman's duty to control its partners and agents, as well as its past employees, in situations such as this extends only to transactions with or by these parties where Rodman is itself involved. To extend it further would be to impose liability upon Rodman for virtually any act of its past or present employees

73. *Id.* at 710.

The court stated that the appropriate test of control was one which had been enunciated in *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). In that case, the court observed:

The statute is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a "controlling person" liable.

*Id.* at 738. However, these observations related to the construction appropriate to the term inducement under section 20 and not to control. *Id.*

74. 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973).

and partners regardless of how remote and unrelated that act might be to Rodman & Renshaw. We are not inclined to read Section [20] so expansively.<sup>75</sup>

Thus, the court concluded that it is at least necessary to demonstrate that a defendant was involved, or apparently involved, in a transaction before controlling persons liability will attach. Such a limiting construction appears required to assure that the scope of liability for securities law violations does not outstrip the scope of responsibility.

### B. Liability of Corporation-Issuers as Controlling Persons

#### 1. Liability for Violations of Securities Laws by Employees

Principles of agency are generally considered appropriate vehicles for establishing the liability of corporation-issuers for employee violations.<sup>76</sup> The same courts which have considered themselves foreclosed by the express language of the controlling persons provisions from applying principles of agency to determine the liability of broker-dealers for employee violations<sup>77</sup> have not considered themselves similarly constrained in evaluating the liability of corporation-issuers for the misdeeds of their officers and employees. In *SEC v. Lum's*, the court stated:

In general, courts have held a corporation-issuer liable on agency principles for what can be deemed the corporate acts of its principal agents without much discussion, and it seems to me that this is the appropriate analysis — if only because it is difficult to conceive of a corporation acting in any other way than by its managing officers and directors.<sup>78</sup>

75. *Id.* at 39-40.

76. In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), the corporation was clearly considered to be responsible for the misstatements of its managing persons which were made in their corporate capacities. 401 F.2d at 857-62. Whether the court considered the liability of Texas Gulf Sulphur to be primary, as a participant in the violation, or secondary, under the agency theory, is not clear. In *Moerman v. Zipco*, 302 F. Supp. 439 (S.D.N.Y. 1969), *aff'd on other grounds*, 422 F.2d 871 (2d Cir. 1970), the court stated that an issuer was liable for the corporate act of its president under principles of agency. 302 F. Supp. at 447. *See also* *SEC v. Lum's*, 365 F. Supp. 1046, 1061 (S.D.N.Y. 1973).

Certain conceptual difficulties arise when agency theory is used to analyze the liability of a corporation for the misstatements of its agents. Most circuits hold that some form of scienter, a defendant's knowledge of facts omitted or misstated, is an element of a rule 10b-5 action. *See* Bucklo, *Scienter and Rule 10b-5*, 67 N.W. U.L. REV. 562 (1973), for a general discussion of the scienter question. Under the agency theory, the knowledge of agents is imputed to a corporation. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301 n.20 (2d Cir. 1973). Jennings and Marsh have noted that even where a corporate agent makes an innocent misstatement, it is very likely that another agent, not a participant in the statement, would know of the falsity of the statement. R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS*, 1358 (3d ed. 1972). Under the agency theory, the liability of the corporation, charged with the act of the maker of the statement and the knowledge of the non-participant, would be virtually absolute. In order to resolve this dilemma, the Second Circuit has suggested that it is appropriate to analyze the scienter of the corporation by focusing on intent with which the statement was made or drafted. Gerstle v. Gamble-Skogmo, Inc., *supra* at 1301 n.20.

77. *See* notes 39-55 and accompanying text *supra*.  
78. 363 F. Supp. at 1061.



The controlling persons provisions have generally been utilized to expand the scope of the corporation-issuer's liability beyond the limits imposed by agency principles. *Gordon v. Burr*<sup>79</sup> provides a good example of the approach taken by the courts — examine possible agency liability first and if that does not lie, then turn to an examination of possible controlling persons liability. In *Gordon*, the president of Elpac Corporation fraudulently agreed to sell the plaintiff some of his own shares in the corporation. The court held that Elpac was not liable under agency theory since the president's act was not a "corporate act" and was committed outside the scope of his employment.<sup>80</sup> The court then considered Elpac's possible liability under section 20(a), rejecting the plaintiff's claim because he had failed to demonstrate that Elpac had controlled its president's actions. The court stated:

The question of Elpac's liability is a difficult one largely because plaintiff has failed to produce any greater evidence of Elpac's involvement than the fact that Burr was for a time Elpac's president. If I were to find Elpac liable, it would be on this fact alone, and I am unwilling to reach such a conclusion. My refusal to hold Elpac liable here is less a reflection on Elpac's role than a comment on the exceedingly meagre state of the record. Before a defendant is required to meet its burden of good faith under §20(a), plaintiff must make a *prima facie* showing that the defendant in some meaningful sense "controlled" the actions of one liable under §10(b). I find no evidence in this record of control, direct or indirect of Burr by Elpac in what were clearly not corporate acts. I therefore held that Elpac is not liable under §20(a).<sup>81</sup>

Thus the framework of analysis of corporate liability for violations by employees developed by the court is two-fold. If the act committed by the employee is a "corporate act," that is committed within the scope of his employment, liability may lie under agency theory. If, however, the act is not a "corporate act," liability may nevertheless ensue under the controlling persons sections. However, it must appear that the corporation was involved in the transaction and in some "meaningful" sense controlled the actions of the employee for these provisions to apply.

In *Richardson v. MacArthur*,<sup>82</sup> liability under section 20(a) was extended beyond the bounds suggested in *Gordon*. Bonneville, a Utah insurance corporation, was held liable for the fraud of an employee which it had hired as a general agent to manage the expansion of its business into California. The agent, MacArthur, enlisted the aid of the plaintiff, Richardson, in developing Bonneville's California insurance business. Learning that Richardson desired to invest in Bonneville, MacArthur fraudulently agreed to sell him some of his own Bonneville securities which Richardson understood were to come from MacArthur and not from Bonneville. When MacArthur

79. 366 F. Supp. 156 (S.D.N.Y. 1973).

80. *Id.* at 169-70.

81. *Id.* at 170.

82. 451 F.2d 35 (10th Cir. 1971).

failed to deliver the shares for which he had paid, Richardson sought to hold Bonneville liable. The court evaluated the firm's liability under section 20(a), applying an expansive and somewhat amorphous test of control, stating:

Liability under §20(a) is not restricted by principles of agency or conspiracy. "The statute is remedial and to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence to hold a 'controlling person' liable." Directing attention to the evidence of Bonneville's relationship with MacArthur, it is plain that Bonneville was a controlling person within the meaning of §20(a).<sup>83</sup>

The court recited facts which it considered indicative of Bonneville's control:

MacArthur was the man selected by Bonneville to develop Bonneville in California. In this capacity and with the knowledge and consent of Bonneville's officers, MacArthur not only set up Bonneville's agency in California and obtained certification for Bonneville to sell insurance there, but he also prospected California for mergers and acquisitions. In sum, he dealt with practically any matter affecting Bonneville in California. Since MacArthur regularly reported to Bonneville's executive committee concerning those vast dealings which he was undertaking for Bonneville in California, it cannot now be claimed that Bonneville lacked the influence to control, direct or discipline MacArthur with regard to those dealings.<sup>84</sup>

While the facts recited demonstrate that MacArthur had broad authority to act for Bonneville with respect to its California operations and that he reported regularly to Bonneville with respect to those operations, they fail to indicate that Bonneville in any way controlled MacArthur's personal transactions in Bonneville shares. There was no evidence that Bonneville was involved in the transaction or that it controlled the conduct which gave rise to the violation. The limits suggested in *Gordon* and not followed in *Richardson* appear the best approach. If they are not adopted, it seems that issuers may be subject to unlimited liability for the personal transactions of employees in their shares.

## 2. Other Expansions of the Scope of Liability Under the Controlling Persons Provisions

The controlling persons provisions have been used to expand the scope of corporate liability in other respects. In *DeMarco v. Edens*,<sup>85</sup> the liability of an issuer for the fraud of a "best efforts"<sup>86</sup> underwriter was

83. *Id.* at 41-42, quoting *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). See note 73 *supra* regarding the inappropriateness of the quoted language as a test of control.

84. 451 F.2d at 42 (footnote omitted).

85. 390 F.2d 836 (2d Cir. 1968).

86. "Best efforts" underwriting is one of the two most widely used techniques for the distribution of corporate securities to the investing public. The second method

analyzed under section 15. Indicating that it had "serious doubts" concerning the characterization of the issuer as a controlling person of the underwriter, but assuming that it was, the court held that the issuer had sustained its section 15 defense of lack of knowledge.<sup>87</sup> In *Hill York Corp. v. American Int'l Franchises*,<sup>88</sup> a corporate franchisor was held to be a controlling person of a franchisee which had sold securities in violation of the securities laws. The court found control in the defendants use of the franchise agreement which it characterized as a "Damocles sword [used] in compelling compliance with [the defendants'] wishes."<sup>89</sup>

### 3. Summary

The controlling persons provisions have been used to develop an expansive scope of possible liability for corporation-issuers. Such expansion seems desirable to the extent that it furthers the drafters' goal of extending liability to those responsible for securities law violations. The *Richardson* case, however, indicates that there is a need to define the limits of control to prevent extensions of liability beyond the point where the Congressional purpose would be served.

#### C. Corporate Directors as Controlling Persons

The law regarding the liability of corporate directors for the fraudulent acts of others within their corporation and in which they did not personally participate is at present unsettled. At common law, a director was not liable under agency principles for the fraudulent acts of other directors or officers of his corporation.<sup>90</sup> Therefore, proof that a director had participated in a corporate act of fraud was a prerequisite to any imposition of liability.<sup>91</sup>

With only one exception, the federal securities laws do not expressly address the problem of the liability of directors for corporate acts of

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is "firm-commitment" underwriting where the issuer sells his securities to a group of securities firms composing an "underwriting group", who resells the securities at a price differential to a group of dealers constituting a "selling group". The "selling group" then distributes the securities to the public at a profit. This form of underwriting does not involve any arrangements which could be characterized as control relationships because at each stage the firm involved acts as a principal, deriving compensation from the profit on the resale rather than from a commission paid by the issuer. "Best efforts" underwriters, on the other hand, can more readily be described as controlled persons of the issuer because the firm involved does not buy the securities from the issuer. Instead, the underwriter sells the securities for the issuer as his agent, deriving compensation through commissions on the sale. See generally 1 L. LOSS, *SECURITIES REGULATION* 159-172 (2d ed. 1961).

87. *Id.* at 841-42.

88. 448 F.2d 680 (5th Cir. 1971).

89. *Id.* at 694.

90. See *Rives v. Bartlett*, 215 N.Y. 33, 109 N.E. 83 (1915); 3 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1150, at 825-27 (1965).

91. See 3 W. FLETCHER, *supra* note 89.

fraud.<sup>92</sup> However, several cases have considered the liability of non-participating directors under general anti-fraud provisions such as rule 10b-5<sup>93</sup> and rule 14a-9<sup>94</sup> promulgated under the 1934 Act, while others have evaluated the liability of such directors under section 20(a).<sup>95</sup> Where a director has not personally participated in a fraudulent act, it would appear more appropriate to consider his liability under the controlling persons provisions than directly under the general anti-fraud provisions since violation of the anti-fraud provisions has generally been held to require some degree of participation in the fraud, either as a principal, an aider-and-abettor, or a conspirator.<sup>96</sup>

### 1. *Appropriateness of the Characterization of Directors as Controlling Persons*

The question of whether an individual is a controlling person of a corporation by virtue of director status alone is presently undecided. One court has stated, "The conclusion is inescapable that persons who act as directors are in control of the corporation."<sup>97</sup> However, another court has concluded that a director was not a controlling person where he had been a board member for only a short time when the fraudulent corporate act on which liability was predicated occurred.<sup>98</sup> In most cases in which the courts have found directors to be controlling persons, both indicia of control and director status have been present.<sup>99</sup> A recent study of the conduct and functions of corporate directors supports the conclusion that they should not be regarded as controlling persons per se. The study in-

92. Section 11(a) (2) of the 1933 Act, 15 U.S.C. § 77k(a) (2) (1970), expressly imposes liability upon directors of issuers which have filed false or misleading registration statements, subject to the "due diligence" defenses contained in subsection (b) thereof, 15 U.S.C. § 77k(b) (1970). The leading cases concerned with the construction of the "due diligence" defenses as applied to directors is *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (D.C.N.Y. 1968).

93. 17 C.F.R. § 240.10b-5 (1973), promulgated under 15 U.S.C. § 78j(b) (1970). See *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), for constructions of rule 10b-5 in connection with the liabilities of non-participating directors.

94. 17 C.F.R. § 240.14a-9 (1973), promulgated under Section 14 of the 1934 Act, 15 U.S.C. § 78n(a) (1970). See *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 853 (D. Del. 1972), for a construction of rule 14a-9 in connection with the liability of non-participating directors for false or misleading proxy solicitation statements.

95. See *Mader v. Armel*, 461 F.2d 1123 (6th Cir.), cert. denied, 409 U.S. 1023 (1972); *Moerman v. Zipco*, 302 F. Supp. 439 (S.D.N.Y. 1969), aff'd on other grounds, 422 F.2d 871 (2d Cir. 1970).

96. See generally *Ruder*, supra note 4, for a study of the elements of the various theories commonly used to impose secondary liability under the federal securities laws.

97. *Moerman v. Zipco*, 302 F. Supp. 439, 447 (S.D.N.Y. 1969), aff'd on other grounds, 422 F.2d 871 (2d Cir. 1970).

98. *Mader v. Armel*, 461 F.2d 1123, 1125 (6th Cir.), cert. denied, 409 U.S. 1023 (1972).

99. See, e.g., *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 275-76 (10th Cir. 1957) (director was also an organizer of corporation as well as its vice-president); *Whitfield v. Whitfield*, 222 F.2d 808 (10th Cir. 1957) (director was also substantial shareholder of corporation as well as its president).

dicates that outside directors rarely exercise effective control of their corporation.<sup>100</sup> Instead, they serve primarily as advisors to the management of their corporations on matters within their special areas of competence or experience.<sup>101</sup>

## 2. *The Special Defenses*

There is relatively little case law construing the "good faith" standard of section 20(a) with regard to the liability of non-participating directors. One court has stated that directors should not be required to exercise the same sort of rigorous supervision over the managing officers of their corporations that brokers are required to exercise over their employees and salesmen because they lack the *ability* to exercise such a degree of control.<sup>102</sup> Another court has held a director who had negligently failed to detect fraud perpetrated by the president of his corporation to have nevertheless sustained his defense of good faith where it appeared that he himself had been deceived by the president's acts.<sup>103</sup> Similarly, two recent decisions involving the liability of non-participating directors under rule 10b-5 have held proof of willful or reckless conduct a prerequisite to the imposition of liability.<sup>104</sup> Yet, the argument that liability should be imposed upon such directors for negligent failure to discover corporate acts of fraud has also been forcefully made.<sup>105</sup>

The most important decision to date concerning the liability of non-participating directors is *Lanza v. Drexel & Co.*<sup>106</sup> While the case was decided under rule 10b-5 rather than under the controlling persons provisions, the rationale advanced by the court in support of the standard of culpability therein developed will undoubtedly influence future constructions of the section 20(a) "good faith" defense.

*Lanza* involved the liability under rule 10b-5 of an outside director of BarChris Construction Corporation for deceit practiced by its managing officers in the course of the acquisition of another corporation. The defendant, who sat on the BarChris board as a representative of an investment firm, had not personally participated in the negotiations leading to the exchange of shares by which the acquisition was effected. However, at the time he voted to approve the contract of exchange he was aware that

100. M. MACE, DIRECTORS: MYTH AND REALITY, 184-90 (1971).

101. *Id.* at 178-84.

102. Moerman v. Zipco, 302 F. Supp. 439, 447 (S.D.N.Y. 1969), *aff'd on other grounds*, 422 F.2d 871 (2d Cir. 1970).

103. Mader v. Armel, 461 F.2d 1123, 1126 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).

104. SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973).

105. See *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1317-20 (2d Cir. 1973) (Hays, J., dissenting); Address by A.A. Sommer, Jr., Commissioner, Securities and Exchange Commission, to Colorado Association of Corporate Counsel, Denver, Colorado, Feb. 21, 1974, in CGH Fed. Sec. L. Rep. [Current Binder] ¶ 79,669 (1974).

106. 479 F.2d 1277 (2d Cir. 1973) (en banc).

BarChris had suffered several recent business reversals and that its management had been shaken by dissension. He also was aware that several months earlier BarChris had issued a financial report to the public which was misleadingly optimistic. The issue presented was thus whether the defendant had breached any duty under rule 10b-5 by failing to inquire whether all material, adverse information had been conveyed to the plaintiffs when he voted to approve the transaction.<sup>107</sup>

The court concluded that he had not breached any such duty on the basis of two general propositions:

[A] director in his capacity as a director (a non-participant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits. A director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary such as that of an aider and abettor, a conspirator, or a substantial participant in the fraud perpetrated by others.<sup>108</sup>

Applying these principles to the facts of the case the court held that the defendant (1) did not owe an affirmative duty to scrutinize the negotiations prior to giving his approval to the sale, and (2) was not an aider and abettor of, a conspirator in, or a substantial participant in the fraud practiced by the others.<sup>109</sup>

The court also rejected the plaintiffs' contention that, if the failure of the defendant to ascertain what information had been conveyed to them, in view of his knowledge of adverse developments within BarChris, were negligent, he should be found liable under rule 10b-5 for a negligent omission to state material facts. The court held that scienter, "a willful or reckless disregard for the truth," was necessary to the imposition of liability under the rule<sup>110</sup> and indicated that the responsibilities of the

107. *Id.* at 1281.

108. *Id.* at 1289 (footnote omitted).

109. *Id.* at 1309.

110. *Id.* at 1306. It appears clear that the court would have held the defendant liable had scienter been proved. However, the theory of liability which would have been utilized is not clear. It is possible that the defendant would have been liable *primarily* under the rule for an omission to state material facts. Yet, the opinion strongly suggests that his liability could *only* have been *secondary*, as an aider and abettor of, a conspirator in, or a substantial participant in, the fraud. *Id.* at 1269, 1309. If this is so, a problem arises with respect to the act requirement under such theories. The opinion does not discuss the elements of such theories, but refers to the Ruder article, *supra* note 4. Professor Ruder indicates that in addition to some form of *scienter*, conspiracy requires an agreement with, while aiding and abetting requires significant assistance or encouragement to the primary wrongdoers. The theory of substantial participation is not discussed. *See* Ruder, *supra* note 4, at 620-28. In *Lanza*, it appears that the defendant's vote to approve the contract of exchange would have satisfied the requirement of significant assistance or encouragement. But, in cases involving transactions not requiring director approval, it is unclear whether merely knowing acquiescence in the fraudulent acts would satisfy this requirement.

defendant within the corporation would be a substantial factor in determining whether his conduct was reckless :

In determining was [sic] constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort. . . . The answer to the inquiry will of course depend upon the circumstances of a particular case, including the nature and duties of the corporate positions held by the defendants.<sup>111</sup>

It is therefore possible that an inside director, possessed of the same degree of notice as the defendant in *Lanza*, might have been held to have acted recklessly.

Judge Hays, dissenting, disagreed with the majority over the necessity of scienter for the imposition of liability under the rule. He considered that a negligence standard might be appropriate in certain cases, depending upon the circumstances and the relationship of the parties. In particular, he contended that the business and financial sophistication of the defendant, the respect in which he was held on the BarChris board, and his knowledge of corporate adversity made the imposition of liability for a negligent failure to ascertain the nature of the information conveyed to the plaintiffs appropriate.<sup>112</sup>

*Lanza* highlights the delicate nature of the balancing process involved in developing standards of culpability in securities fraud cases. The remedial value which would be served by the imposition of a particular standard must be weighed against the possible resultant disruption to honest business activity. Although, a negligence standard in such a case would afford maximum protection to the investing public, the imposition of that standard, as the *Lanza* majority noted, might severely disrupt the honest transaction of business by corporations :

When we move toward the kind of novelty plaintiffs propose for one in the position of the [defendant], it may not be amiss to recall the ambiguities of real life. A director like [the defendant] not involved in the daily business [of a corporation], may think he "knows" things contrary to what he is told by the management upon which he must perforce rely. He may be wrong. His primary loyalties are familiar and stern ones. How and when he must — or may — run off to "warn" or advise outsiders dealing with his corporation could suggest questions of great refinement. At the very least, such action would

111. 479 F.2d at 1306 n.98 (citation omitted). The subjective beliefs of a defendant would also appear to be a relevant factor. Thus, the *Lanza* court noted the defendant's apparent belief in the integrity of the BarChris management. *Id.* at 1306. Similarly, in *Mader v. Armel*, 461 F.2d 1123 (6th Cir.), cert. denied, 409 U.S. 1023 (1972), the court considered evidence that the defendant himself had been deceived to be relevant on the issue of "good faith" under § 20(a). *Id.* at 1125.

112. *Id.* at 1317-19 (Hays, J., dissenting).

violate the decorum of the management hierarchy; at most, it could cost him his seat on the board and a judgment for interfering with a corporate opportunity. If people of stature and creative potential are still wanted for corporate directorships, we must take care how agonizingly subtle their choices are to be. . . . In short, if the type of liability plaintiffs urge should ever be imposed, it ought to be reasonably clear that the wrong is palpable and the balance of advantage lies in that course.<sup>113</sup>

### 3. Summary

It would appear that a director is not per se a controlling person of his corporation. Other factors, in addition to director status, should be demonstrated before controlling person status attaches. In addition the weight of authority requires scienter as a prerequisite to the imposition of liability upon directors who have not personally participated in the perpetration of corporate acts of fraud. Finally, the nature and duties of a defendant's corporate position are factors to be considered in determining whether his conduct is culpable.

## IV. CONCLUSION

The legislative purpose underlying the enactment of the controlling persons provisions was to supplement traditional theories of secondary liability in order to insure that those responsible for violations of the securities laws would be caught. The provisions, however, have proved, in some respects, to be inadequate for that task. For example, although it appears clear that the drafters intended to supplement traditional theories of vicarious liability,<sup>114</sup> the express terms of the provisions indicate that they have replaced rather than supplemented agency as a theory of liability.<sup>115</sup> The result is, in some cases, a contraction, rather than an expansion of the scope of liability. On the other hand, the absence of a definition of the term "control" in the provisions creates the possibility of an overexpansive scope of liability. Without definite criteria to limit their application, it is possible that these sections could be utilized to extend liability beyond any relationship considered by the drafters.

The language of the special defenses has proved unwieldy in defining standards of responsibility within the relationship to which the controlling persons provisions have been applied. The responsibilities of a broker-dealer in overseeing the activities of its salesmen are quite different from those of a director of a corporation in overseeing the activities of the corporation's employees. Yet, the controlling persons provisions make "good faith" the measure of each. Not surprisingly, the same courts have given

113. *Id.* at 1307 (footnote omitted), quoting *Lanza v. Drexel & Co.* [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 at 90, 105 n.18 (S.D.N.Y. Oct. 9, 1970).

114. See notes 10-30 and accompanying text *supra*.

115. See notes 38-41 and accompanying text *supra*.



different interpretations to this same language in different contexts, while different courts have given the language different interpretations in similar contexts.<sup>116</sup> The result is some confusion concerning the responsibilities of persons who may be characterized as “controlling persons.”

These observations suggest that revision of the controlling persons provisions is advisable. The relationship of the sections to theories of agency ought to be clarified and the criteria of control should be set forth. Finally, specific provisions ought to be drafted to better define standards of responsibility in those areas in which the provisions have been applied with some regularity. The controlling persons provisions themselves should be retained to govern those unusual and non-recurring situations in which traditional theories of secondary liability are not adequate to impose sanctions upon those who are responsible for violations of the securities laws.

*Kenneth I. Levin*

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116. Compare notes 76-84 and accompanying text *supra* with notes 42-55 and accompanying text *supra*.