SECURITIES—VICARIOUS LIABILITY RESPONDEAT SUPERIOR APPLICABLE IN CASES INVOLVING HIGH FIDUCIARY DUTIES DESPITE CONTROLLING PERSONS PROVISION OF SECURITIES EXCHANGE ACT—*Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981).

The application of agency principles in the context of federal securities law violations has long been a cause of dissension among the various circuit courts of the United States.[1] The conflict has arisen over whether section 20(a) of the Securities Exchange Act of 1934, which provides that controlling persons may be liable for the securities violations of others,[2] supplants the common law doctrine of respondeat superior.[3] Of the circuit courts which have considered

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[1] Cases which have considered this problem include: Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 101 S. Ct. 566 (1981) (brokerage house responsible for employee's fraudulent misrepresentation under doctrine of respondeat superior); Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978) (doctrine of respondeat superior replaced as theory of liability by section 20(a)); Rochez Bros., Inc. v. Rhoades, 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976) (adoption of section 20(a) makes application of respondeat superior inappropriate); Sherman v. Duralite Co., 524 F.2d 577 (3d Cir. 1975) (respondeat superior not applicable as theory of liability against corporation); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975) (controlling corporation's liability arose from section 20(a) rather than respondeat superior); Fey v. Walston & Co., Inc., 493 F.2d 1036 (7th Cir. 1974) (broker liable for action of representative under general agency principles); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971) (application of agency principles not restricted by section 20(a)); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974) (brokerage house partners liable under agency principles for tortious misrepresentation of lower management); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970) (broker-dealer sanctioned for wilful violations of agents under doctrine of respondeat superior); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (dicta implies that agency principles apply to securities violations); Kamen & Co. v. Paul M. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968) (section 20(a) supplants respondeat superior as theory of liability).

[2] Section 20(a) provides that:

> 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 course of action.

15 U.S.C. § 78t(a) (1979).

[3] Respondeat superior is defined as:

> Let the master answer. This maxim meant that a master is liable in certain cases for the wrongful acts of his servant, and a principal for those of his agent. Burger Chef Systems, Inc. v. Govio, C.A. Mo., 407 F.2d 921, 925. Under this doctrine master is responsible for want of care in servant's part toward those to whom master owes duty to use care, provided failure of servant to use such care secured in the course of his employment. Shell Petroleum Corporation v. Magnolia Pipe Line Co., Tex. Civ.App., 85 S.W.2d 829, 832. Doctrine applies only when relation of master and servant existed between defendant and wrongdoer at time of injury sued for, in

this problem, the majority have concluded that section 20(a) and respondeat superior are not mutually exclusive.[4] The Courts of Appeals for the Third, Eighth, and Ninth Circuits, however, have consistently held to the contrary.[5] *Sharp v. Coopers & Lybrand*,[6] a recent Third Circuit decision, will be examined in this Note. *Sharp* is significant in that it indicates a willingness on the part of the court to apply the doctrine of respondeat superior in a limited number of cases, despite the general rule in the Third Circuit that section 20(a) is to be used exclusively.

Westland Minerals Corporation (WMC) served as the promoter of the "Ohio Program," a business venture, from July 1971 until July 1972. The Ohio Program consisted of numerous limited partnerships which were formed for the purpose of raising capital to drill for oil and gas.[7] Each limited partnership was to expend a total of

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> respect to very transaction from which it arose. Hence, doctrine is inapplicable where injury occurs while servant is acting outside legitimate scope of authority. Rogers v. Town of Black Mountain, 224 N.C. 119, 29 S.E.2d 203, 205. But if deviation be only slight or incidental, employer may still be liable. Klotsit v. P.F. Collier & Son Corporation, 349 Mo. 40, 159 S.W.2d 589, 593, 595; Adams v. South Carolina Power Co., 200 S.C. 438, 21 S.E.2d 17, 19, 20.

BLACK'S LAW DICTIONARY 1179 (5th ed. 1979). A conflict also exists with respect to section 15 of the Securities Act, 15 U.S.C. § 77o (1979). This section is similar to section 20(a) in that it imposes vicarious liability on controlling persons while also providing a defense for those who "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.*

4 *E.g.*, Marbury Management v. Kohn, 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 101 S. Ct. 566 (1981); SEC v. Geon. Indus., Inc., 531 F.2d 39 (2d Cir. 1976); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); Fey v. Walston & Co., Inc., 493 F.2d 1036 (7th Cir. 1974); Sennott v. Rodman & Renshaw, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., [1978] FED. SEC. L. REP. (CCH) ¶96,537 (S.D.N.Y. 1978).

5 *E.g.*, Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); Rochez Bros., Inc. v. Rhoades, 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 423 U.S. 993 (1976); Thomas v. Duralite Co., 524 F.2d 577 (10th Cir. 1975); Klapmeier v. Telecheck Int'l, Inc., 482 F.2d 247, 256 (8th Cir. 1973); Kamen & Co. v. Paul M. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. denied*, 393 U.S. 801 (1968).

6 649 F.2d 175 (3d Cir. 1981). Publication of the court of appeals decision brings the total number of published decisions in this matter to five. The four district court opinions are: Sharp v. Coopers & Lybrand, 491 F. Supp. 55 (E.D. Pa. 1980) (court rendered judgment after consideration of jury's answers to interrogatories); Sharp v. Coopers & Lybrand, 83 F.R.D. 343 (E.D. Pa. 1979) (court discussed interrogatories and various theories of damages employed at second trial on individual issues); Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978) (court considered several motions at conclusion of first trial on class issuer); Sharp v. Coopers & Lybrand, 70 F.R.D. 544 (E.D. Pa. 1976) (court granted plaintiffs' class certification).

7 649 F.2d at 178.

$140,000. Of this sum, $65,000 was to be paid by investors in the limited partnership, and the balance was to be supplied by banks and other lending institutions.[8] In April of 1971, WMC and Economic Concepts, Inc. (ECI), the selling agent for the limited partnerships, employed the services of Coopers & Lybrand, an accounting firm.[9] Specifically, WMC and ECI requested that an opinion letter be drafted for a potential investor concerning the tax consequences of investment in the limited partnerships.[10]

Coopers & Lybrand drafted the letter which was sent to the president of WMC on July 22, 1971.[11] The letter stated that an investment of $65,000 in the limited partnership would result in allowable tax deductions of $128,000.[12] This letter was written by a tax supervisor and signed by a partner in the firm. In October of 1971, the tax supervisor informed a Coopers & Lybrand partner that the letter was being shown to several other potential investors as part of a general sales program.[13] Because of the increased use of the July 22, 1971 letter, Coopers & Lybrand issued a second, more complete, opinion letter on October 11, 1971.[14] The second letter, which was drafted by the same tax supervisor, likewise maintained that an investor would be able to claim a $128,000 tax deduction for an investment of $65,000.[15]

A major problem arose with respect to the October 11, 1971 letter because it contained material misrepresentations and omissions.[16] Securing large amounts of money through loans was essential

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[8] *Id.*

[9] Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 882 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[10] *Id.* This initial letter was for the use of Muhammed Ali, a potential investor, who was interested in the WMC venture as a method of reducing the taxation of a prizefight purse.

[11] 649 F.2d at 178.

[12] *Id.* Professor Bernard Wolfman, a federal income taxation specialist, testified at the jury trial as to the principles behind this tax shelter. The trial court summarized Professor Wolfman's testimony:

> [A] taxpayer who in 1971 contributed $25,000 to a partnership involved in a bona fide oil drilling venture, which then obtained for each $25,000 contribution an additional $25,000 bona fide bank loan that was fully secured by partnership property (the as yet undrilled wells) and then expended all of that $50,000 for drilling, could under the law applicable in 1971 deduct the full $50,000 from his taxable income.

Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 883 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[13] 649 F.2d at 178.

[14] *Id.*

[15] The third opinion issued by the district court contains an appendix in which the letters of July 22, 1971 and October 11, 1971 are repeated verbatim. *See* Sharp v. Coopers & Lybrand, 83 F.R.D. 343, 353 (E.D. Pa. 1979), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[16] Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 883 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981). Specifically, the trial in this matter was concerned with the

to the success of the plan. The letter failed to mention, however, that the non-recourse loans which lending institutions would presumably make to WMC would have to be secured by collateral.[17] Ideally, this collateral would be the very oil wells which would be purchased.[18] An inherent flaw in this plan, however, was that banks are not willing to advance money upon such collateral because the value of the undrilled wells is unknown.[19] Coopers & Lybrand, therefore, suggested that WMC borrow money from a bank and use the money to purchase savings certificates from the same bank.[20] The bank would then hold the certificates as collateral, resulting in a "paper transaction" whereby WMC would have the loans necessary for the tax shelter on paper, but would never actually receive any money.[21] WMC followed the suggestion of Coopers & Lybrand and conducted the transactions through a bank in the Bahamas which it had acquired in September of 1971.[22]

When WMC was indicted for securities fraud the entire scheme began to unravel.[23] Many of the oil wells had never been drilled,[24]

October 11, 1971 letter because it was used in WMC's general sales program. The bulk of testimony concerning the misrepresentations and omissions was provided by Professor Bernard Wolfman. *See id.* and note 12 *supra*.

[17] Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 883 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[18] *Id.*

[19] *Id.* Several other problems with the October 11 letter vis-a-vis material misrepresentations and omissions also became apparent at trial:

> In particular, evidence suggested that [the tax supervisor] as of October 11: (a) had recommended to WMC that it take the bank loans through mere bookkeeping transactions 'without having to make a bank loan in the normal sense that we think of,' (b) knew that WMC had acquired a bank, International Bank & Trust of the Bahamas (IBI), (c) knew that the IBI was insolvent, or at least unable to make the loans necessary to fund the oil drilling venture contemplated by the WMC limited partnership agreements, and (d) knew that the actual drilling costs for each limited partnership would be less than $140,000.

Id. at 883-84. According to Professor Wolfman, the writer of the October 11, 1971 letter made several misstatements in the letter which resulted in misrepresentations as to the tax consequences of the venture. *Id.*

Professor Wolfman also noted "that it was improper for an employee of an accounting firm who was employed by ECI to write a tax opinion letter and that the failure to disclose his [the tax supervisor's] relationship with the selling agent would be a material omission which would appear to have been intentional or reckless." *Id.* at 884.

[20] 649 F.2d at 179.

[21] *Id.* By way of a footnote, the court mentioned that this "paper transaction" changed the venture from a tax shelter to a " 'Ponzi scheme' in which two investors were necessary to fulfill the obligations owed to one." *Id.* at 179 n.2.

[22] *Id.* at 179.

[23] *Id.*

[24] Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 883 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

many were dry,[25] and much of the money[26] supplied by the investors was diverted for the use of WMC.[27] Shortly after the indictment, the Internal Revenue Service began denying deductions taken by the program's investors.[28] On May 8, 1975, Stanley Sharp filed suit in federal district court against Coopers & Lybrand on behalf of himself and two hundred and ten other WMC investors.[29] Sharp alleged violations of section 10(b) of the Securities Exchange Act of 1934,[30] as well as violations of rule 10b-5.[31] From February 27 to March 10, 1978, a jury trial was held as to the issues which were common to the class.[32] The jury found that the October 11, 1971 opinion letter contained material misrepresentations and omissions.[33] It also determined that the tax supervisor had acted recklessly and intentionally.[34] The trial court concluded as a matter of law that Coopers & Lybrand was responsible for the actions of the tax supervisor under the common law doctrine of respondeat superior, as well as liable

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[25] 649 F.2d at 179.

[26] Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 882 (E.D. Pa. 1978), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[27] 649 F.2d at 179.

[28] *Id.*

[29] *Id.* Class certification was granted by the trial judge on February 19, 1976. *See* Sharp v. Coopers & Lybrand, 70 F.R.D. 433 (E.D. Pa. 1976), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[30] 15 U.S.C. § 78j(b) (1976). This section provides that:

> It shall be unlawful for any person, directly or indirectly, by the issue of any memo or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

[31] 17 C.F.R. § 240.10b-5 (1981). This rule provides that:

> It shall be unlawful for one person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

[32] 649 F.2d at 179.

[33] *Id.* This finding was in response to special interrogatories posed by the trial court. *Id.*

[34] *Id.*

under section 20(a).[35] Coopers & Lybrand appealed the decision of the trial court.[36] One of the arguments advanced on appeal was that the trial judge erred when he held Coopers & Lybrand secondarily liable.[37] Judge Aldisert, writing for the Court of Appeals for the Third Circuit, affirmed the trial court decision because he agreed that respondeat superior should apply in cases which involve high fiduciary duties.[38]

Although the *Sharp* court analyzed several issues,[39] only two are significant for the purpose of this Note: the applicability of respondeat superior, and the scienter requirement in 10b-5 actions. In addressing the issue of respondeat superior,the *Sharp* court first examined *Rochez Brothers, Inc. v. Rhoades (Rochez II)*,[40] a prior Third Circuit case. In *Rochez II*, a corporate president purchased a large block of shares from the corporate vice-president.[41] The president failed to disclose to the vice-president that certain third parties were interested in acquiring the corporation.[42] When the president sold his shares to a

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[35] *Id.*The trial court also found as a matter of law that Coopers & Lybrand was liable for the tax supervisor's conduct under section 20(a) of the Securities Exhange Act of 1934. *Id.*

From May 12 to May 19, 1980, a second jury trial was held concerning the issue of damages. The findings and decisions of this particular trial are of no real import to this Note. The trial court's opinion from this second trial is reported in Sharp v. Coopers & Lybrand, 491 F. Supp. 55 (E.D. Pa. 1980), *aff'd in part, rev'd in part*, 649 F.2d 175 (3d Cir. 1981).

[36] 649 F.2d at 179.

[37] *Id.* at 179-80. On appeal, Coopers & Lybrand raised three other arguments in addition to challenging the applicability of respondeat superior. They were: 1) the district court judge made an error when he neglected to properly instruct the jury with regard to section 20(a) of the Securities Exchange Act of 1934; 2) an error occurred during the second trial when a presumption was created that the class representative relied on the October 11 letter and the misrepresentations and omissions therein; 3) the measure of damages established by the district court was wrong. *Id.* at 180. In addition, the court of appeals considered a host of minor issues raised by Coopers & Lybrand. *Id.* at 191-94.

[38] Judge Aldisert was joined in his opinion by the other two members of the panel, Chief Judge Markey, who sat by designation, and Circuit Judge Higginbotham.

[39] Judge Aldisert also considered the other issues raised by Coopers & Lybrand in its appeal. *See* note 37 *supra*. Briefly, the court of appeals found error in the trial court's failure to instruct the jury with regard to Coopers & Lybrand's liability under section 20(a). In light of its entire holding, however, the appellate court did not find a retrial of the liability issue to be necessary. 649 F.2d at 185. After a rather lengthy analysis, the court held that the trial judge had not erred in his treatment of the reliance issue. *Id.* at 189. The court did, however, take exception to the trial court's determination of the proper measure of damages and, accordingly, remanded the damages issue for retrial with instructions. *Id.* at 191.

[40] 527 F.2d 880 (3d Cir. 1975). There are two Third Circuit cases involving the *Rochez Bros., Inc. v. Rhoades* litigation. In Rochez Bros., Inc. v. Rhoades (*Rochez I*), 491 F.2d 402 (3d Cir. 1974), the court of appeals vacated the district court's judgment as to the application of agency principles to securities violations and remanded with instructions.

[41] 527 F.2d at 883.

[42] *Id.* The corporation's president had retained a third party to seek buyers for the entire corporation. Although this third party did not find the ultimate purchaser of the corporation, he did provide the president with several leads. *See Rochez I*, 491 F.2d 402, 406 (3d Cir.1974).

third party at a great profit,[43] the vice-president filed suit against both the president and the corporation.[44] The court of appeals held that although the district court was correct in finding the president liable under rule 10b-5,[45] the corporation could not be held secondarily liable under the theory of respondeat superior.[46] The *Rochez II* court reasoned that if respondeat superior were applied, the good faith defense provided in section 20(a) would be vitiated and the controlling person held strictly liable, thus expanding liability beyond the bounds envisioned by Congress.[47] Furthermore, the court reasoned that respondeat superior should not be applied because the "controlling persons" provision of section 20(a) requires "culpable participation."[48] In dictum, however, the court acknowledged that respondeat superior should apply in "the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist."[49] The *Sharp* court seized upon this dictum and concluded that the instant case fit within the *Rochez II* exception.[50]

The *Sharp* court maintained that a "stringent duty to supervise its employees"[51] arose in the instant case because Coopers & Lybrand was in a "position in which the investing public would place their trust and confidence in it."[52] Judge Aldisert reasoned that Coopers & Lybrand had placed itself in such a position by issuing a letter upon which it knew the investing public would rely.[53] In short, the court could not distinguish "the responsibility of the accounting firm here from the broker-dealer discussed in *Rochez II*."[54]

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[43] 527 F.2d at 883. The corporate president bought the vice-president's stock for $598,000. Eleven months later, he and two others to whom he had sold stock sold the entire corporation for $4,250,000, in addition to other consideration. *Rochez I*, 491 F.2d 402, 406 (3d Cir. 1974).

[44] 527 F.2d at 883.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.* at 886.

[49] *Id.* at 885.

[50] 649 F.2d at 181. The court also relied upon Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 101 S. Ct. 566 (1980), for the proposition that respondeat superior should apply in the limited context of broker-dealers. Reliance upon *Marbury* is misplaced, however. The *Marbury* court did not limit its holding to the facts of that case which involved a broker-dealer relationship. On the contrary, the court believed that Congress intended to broaden available remedies when it enacted section 20(a), and that respondeat superior should apply generally. *Id.* at 716.

[51] 649 F.2d at 184 (quoting *Rochez II*, 527 F.2d 880, 886 (3d Cir. 1975)).

[52] *Id.* at 183.

[53] *Id.* at 184-85.

[54] *Id.* at 184.

Judge Aldisert could very well have ended his analysis at this point. Instead, he chose to examine case law in other jurisdictions. He noted that other courts have applied respondeat superior in cases involving high level employees[55] or brokerage firms,[56] and that courts have emphasized the public trust of these firms.[57]

Furthermore, the court put forth a policy argument in support of its position. The court reasoned that if respondeat superior were not applicable in such a case, a "Chinese wall" might be erected between the partners in an accounting firm and its employees.[58] There would be a strong incentive for partners not to use their expertise and to let lower level employees deal in matters involving the public, since by doing this the firm would never be held liable.[59] The court noted, however, that because of the vital role which accounting firms play in our society, its holding must, of necessity, be of limited scope.[60] Were it otherwise, the "hazards of rendering expert advice" might become too great.[61]

Finally, the court dealt summarily with the issue of whether the scienter requirement in rule 10b-5 actions precludes a finding of liability on the part of Coopers & Lybrand. The court recognized that the standard of scienter to be applied in a rule 10b-5 case is that of recklessness.[62] Coopers & Lybrand argued that it could not be held liable since recklessness was not shown on its part.[63] The court held

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[55] *Id.* at 182. *E.g.*, Holmes v. Bateson, 583 F.2d 542 (1st Cir. 1978) (respondeat superior applied to hold newly incorporated partnership liable for activities of two of four former partners); Krebs v. Fall River Indus., 502 F.2d 731 (10th Cir. 1974) (corporation responsible for president's fraud); Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970) (officers and directors of bank made up significant portion of class of defendants).

The court noted that the activities of high level officers and directors binds a corporation primarily and, therefore, makes the application of respondeat superior unnecessary. 649 F.2d at 184 n.8.

[56] 649 F.2d at 182. *E.g.*, Henrickson v. Henrickson, 640 F.2d 880 (7th Cir. 1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Holloway v. Howerdd, 536 F.2d 690 (6th Cir. 1976); Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

[57] 649 F.2d at 182. *See* Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974).

[58] 649 F.2d at 184. For a full discussion of the "Chinese Wall" and its role in the securities field, see Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problem of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975).

[59] 649 F.2d at 184.

[60] *Id.*

[61] *Id.*

[62] In the context of rule 10b-5, "scienter" is defined as "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1975).

[63] 649 F.2d at 193. The *Sharp* court cited the following definition of "reckless conduct": "[A] highly unreasonable statement or mission involving not merely negligence or inexcusable

that recklessness need not be shown on the part of Coopers & Lybrand because the accounting firm "owed a duty of careful supervision to the investors, enforceable by the common law doctrine of respondeat superior."[64] So long as the employee acted recklessly, Coopers & Lybrand could be held liable.[65]

There are various ways in which a person can be held liable for the acts of another under the common law. Vicarious liability is generally based upon an existing relationship between the tortfeasor and the person sought to be held liable.[66] For example, where an employer-employee relationship exists, an employer who controls the actions of his employee can be found liable under the doctrine of "respondeat superior."[67] Where a principal-agent relationship exists, a principal can be held liable for the acts of his agent under the doctrines of actual or apparent authority.[68] "[T]he modern justification for vicarious liability is a rule of policy, a deliberate allocation of a risk."[69] In the corporate context, the concept of vicarious liability has been used by plaintiffs to reach "a deeper pocket."[70] Attempts to impose liability based upon the apparent authority of an agent, however, have generally proved unsuccessful because plaintiffs who buy shares over the exchanges usually cannot prove reliance.[71] Nonethe-

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negligence, but an extreme departure from standards of ordinary care, presenting a danger of misleading buyers that is either known to the defendant or is so obvious that the defendant must have known it." *Id.* (quoting McLean v. Alexander, 599 F.2d 1190 (3rd Cir. 1979) (appendix)).

[64] *Id.* at 194.

[65] *Id.*

[66] W. PROSSER, *infra* note 68, at § 69.

[67] *Id.* at 458. *See* note 3 *supra*.

[68] These included the doctrine of apparent authority and actual authority, both implied and express. Actual authority is defined as "the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him." RESTATEMENT (SECOND) OF AGENCY § 7 (1957). For a brief discussion of implied and express authority, see *id.*, comment c. Apparent authority is defined as "the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." *Id.* § 8. *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS §§ 69-70, at 458-67 (4th ed. 1971).

[69] W. PROSSER, *supra* note 68, § 69, at 459.

[70] *See generally* Note, *The Burden of Control—Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1020 (1973) [hereinafter cited as *N.Y.U. Note*]; Note, *The "Controlling Persons" Liability of Broker-Dealers for Their Employee's Federal Securities Violations*, [1974] DUKE L.J. 824 [hereinafter cited as *Duke Note*].

[71] *N.Y.U. Note*, *supra* note 70, at 1030. *E.g.*, Sennott Rodman & Renshaw, 474 F.2d 32 (7th Cir. 1973) (brokerage house not liable absent showing that plaintiff relied upon former employee's apparent authority). In the majority of cases, apparent authority will not be available as a theory of liability because of the reliance requirement. In faceless transactions occurring over the stock exchanges, it is impossible to prove that one relied upon an agent's apparent authority. *N.Y.U. Note*, *supra* note 70, at 1030.

less, the doctrine of respondeat superior has often been used to impose strict liability on a corporation for the acts of its employees even though the doctrine traditionally has not been applied where an employee acts for purely personal motives.[72] Where an employee acts outside the scope of his employment, a court may apply the doctrine if it finds that "the master [is] under such a duty to the plaintiff that responsibility for the servant's acts may not be delegated to him."[73]

Upon enactment of section 20(a), it was thought by some that these common law principles had been preempted.[74] 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.[75]

Obviously this section provides for several defenses which would not be available at common law. A defendant may argue that he is not a controlling person, or that he has acted in good faith and did not induce the violation. With respect to the controlling person requirement, there has been much confusion in the courts because Congress

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[72] *N.Y.U. Note*, *supra* note 70, at 1030.

[73] W. PROSSER, *supra* note 68, § 70, at 465. There are several situations in which an employer may be held liable despite the fact that the employee was not acting within the scope of his employment.

> (2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:
> (a) the master intended the conduct of the consequences, or
> (b) the master was negligent or reckless, or
> (c) the conduct violated a non-delegable duty of the master, or
> (d) the servant purported to act or speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

RESTATEMENT (SECOND) OF AGENCY § 219 (1957). Traditionally, an employer could be held liable for reckless conduct. As discussed in text at notes 123-26 *infra*, this is in harmony with the scienter requirement. It is argued below that no person should be held secondarily liable for merely negligent conduct. Therefore, whenever conduct is "reckless," it is possible for a person to be found liable under either section 20(a), or respondeat superior, regardless of whether the employee acted outside the scope of his employment.

[74] *E.g.*, Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities Exchange Act*, 15 CAL. W. L. REV. 152, 154, 171-73 (1979); *Duke Note*, *supra* note 70, at 827, 837-38. *Contra*, Note, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Persons Sections*, 15 WM. & MARY L. REV. 713, 715, 723 (1974) [hereinafter cited as *William & Mary Note*]; *N.Y.U. Note*, *supra* note 70, at 1021, 1034-41.

[75] 15 U.S.C. § 78t(a) (1976) (emphasis added).

never defined the term.[76] Securities Exchange Act rule 12b-2(f), however, states that control means "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[77] This definition has been applied to section 20(a) cases.[78] Some courts have held that there is a presumption that a director or officer of the corporation is in control.[79] The majority of courts, however, have held that actual control must be present.[80] The majority view seems to be consistent with the legislative history to section 20(a).[81] With respect to the good faith defense, courts have struggled to determine whether a

[76] 527 F.2d at 890 n.19.

> It was thought undesirable to attempt to define the term "control". It would be difficult if not impossible to enumerate or to anticipate the many ways in which control may be exerted. A few examples of the methods used are stock ownership, lease, control; 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 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).

[77] 17 C.F.R. § 240.12b-2(f) (1981).

[78] 1 A. BROMBERG, SECURITIES LAW § 4.7(634), at 88.105 (1975). *E.g.*, *Rochez II*, 527 F.2d at 890; Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 464 F. Supp. 528, 538 (D. Md. 1978); Harriman v. E. I. DuPont De Nemours & Co., 372 F. Supp. 101, 104-05 & n.2 (D. Del. 1974). *But see* A. JACOBS, THE IMPACT OF RULE 10b-5 § 40.04, at 2-131 n.7 (1980) (most cases have not relied upon rule 12b-2(f)). *See generally* 2 L. LOSS, SECURITIES REGULATION 764-83 (1961).

[79] *E.g.*, Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970). *See N.Y.U. Note*, *supra* note 65, at 1022; Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (actual control not necessary—only need influence).

[80] *E.g.*, Sennott v. Rodman & Renshaw, 474 F.2d 32, 39 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); Stern v. American Bankshares Corp., [1977] FED. SEC. L. REP. (CCH) ¶96,033 (E.D. Wis. 1977); Mader v. Armel, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶93,027 (S.D. Ohio 1971), *aff'd*, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972). *See generally* Sommer, "*Who's 'In Control'?—S.E.C.*," 21 BUS. LAW. 559, 562-83 (1966).

To determine "control" one commentator has suggested that the following factors are relevant:

> (a) proposition of voting rights (through stock ownership, trust, proxy or otherwise) relative to remaining voting rights and relative to percentages required (by statute, charter, by law, agreement or otherwise) for pertinent acts;
> (b) director, officer, or other positions of power within the company;
> (c) business or financial leverage outside the company, e.g., by customer or supplier relationship or by loan agreement;
> (d) personality factors, and other relationships by family or through business;
> (e) history of past cooperation or opposition;
> (f) with respect to the litigated transaction, who originated the idea, who negotiated it, who reviewed it, who questioned or objected to it, who approved it, and related circumstances.

1 A. BROMBERG, *supra* note 78, § 4.7 (634), at 88.107-08.

[81] Examination of the legislative intent behind section 20(a) confirms this.

> In this section . . . when reference is made to "control" it is intended to include

failure to supervise is sufficient grounds upon which to impose liability.[82] As for the requirement of non-inducement, the issue has been whether an affirmative act is required.[83] At least one commentator believes that mere negligence is not sufficient to show lack of good faith, and that an affirmative act is necessary to show inducement.[84]

Because of the defenses which Congress made available in section 20(a), several courts have concluded that common law principles are generally no longer applicable.[85] The majority of courts, however, has held that section 20(a) does not preclude application of these principles.[86] For example, in *Holloway v. Howerdd*,[87] the Court of Appeals for the Sixth Circuit held that section 20(a) was not intended to preempt the operation of the doctrine of respondeat superior in a case involving unlawful activity on the part of a brokerage firm employee.[88] The court reasoned that the controlling person provision in section 20(a) was intended to expand, rather than restrict, liability.[89] Similarly, in *Fey v. Walston & Co., Inc.*, [90] the Court of

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> actual control as well as what has been called legally enforceble 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 anticipate the many ways in which actual control may be exerted.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934). As one commentator noted, this language can be interpreted to include "control-by-status" as well as actual control. *N.Y.U. Note*, *supra* note 70, at 1923. Reference is made to Handy & Harmon v. Burnet, 284 U.S. 136 (1931), however, a case in which the court "look[ed] for evidence of actual control." *Id.* at 1024.

Furthermore, it was stated in a debate prior to adoption of section 20(a) 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." 78 Cong. Rec. 8095 (1934) (statement of Mr. Lea).

[82] *E.g.*,Sennott v. Rodman & Renshaw, 474 F.2d 32, 39 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973) (good faith requires knowledge of violation); SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) (failure to supervise is lack of good faith); Rolf v. Blyth Eastman Dillen & Co., 424 F. Supp. 1021, 1044 (S.D.N.Y. 1977), *aff'd in part and remanded*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (failure to supervise is lack of good faith).

[83] Some courts have held that a person can be held liable for failing to properly supervise an employee. *E.g.*, SEC v. First Sec. Co. of Chicago, 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972). Others have held that there must be culpable participation. *E.g.*, *Rochez II*, 527 F.2d at 885; Hughes v. Dempsey-Tegeler & Co., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶94,133, at 94,551 (C.D. Cal. 1973).

[84] *N.Y.U. Note*, *supra* note 70, at 1025-26.

[85] *See* note 5 *supra*.

[86] *See* note 4 *supra*.

[87] 536 F.2d 690 (6th Cir. 1976).

[88] *Id.* at 695. *See, e.g.*, Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

[89] 536 F.2d at 694-95. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975). Congress specifically did not define control so as to enable section 20(a) to apply to a wide range of relationships. *See* note 81 *supra*. Most commentators agree that Congress could not have intended to limit remedies for securities violations. *E.g.*, *William & Mary Note*, *supra* note 74, at 718.

[90] 493 F.2d 1036 (7th Cir. 1974).

Appeals for the Seventh Circuit maintained that section 20(a) did not preclude the application of common law principles.[91] Accordingly, the court found a brokerage house liable under respondeat superior for the "churning" of a customer's account by one of its employees.[92]

The theory set forth in *Holloway* and *Fey* finds more explicit support in *SEC v. Management Dynamics, Inc.*,[93] a Second Circuit case. In *Management Dynamics*, the court of appeals affirmed an injunction which was issued against a brokerage firm because of misrepresentations made by the firm's vice-president in charge of trading.[94] The court held that "[section] 20(a) was not intended as the sole measure of employer liability."[95] It noted that the legislative history of section 20(a) did not indicate that Congress intended to supplant common law agency principles,[96] and went on to state that "given the pervasive applicability of agency principles elsewhere in the law, it would take clear evidence to persuade us that Congress intended to supplant such principles."[97] The court explicitly held that the controlling person provision of section 20(a) did not preclude application of common law agency principles.[98] In fact, like the *Holloway* court, it believed that the controlling person provision was meant to expand, rather than limit liability.[99] The court buttressed its holding by pointing out that "person" is defined in the Securities Exchange Act as including corporations.[100] Therefore, the court reasoned that "Congress evidently intended that a corporation might be liable in some instances as a 'person'; and this can only be by virtue of agency principles, since a corporation can act only through its agents."[101] The *Management Dynamics* court, however, stressed the narrowness of its holding.[102] The court simply decided that the firm was liable because of the apparent authority of the vice-president and his ability to mislead the public.[103] It stated: "[W]e intimate no view as to other cases which may involve lesser employees, . . . other

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[91] *Id.*at 1052. *Accord*, Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

[92] 493 F.2d at 1052.

[93] 515 F.2d 801 (2d Cir. 1975).

[94] *Id.* at 813.

[95] *Id.* at 812.

[96] *Id. See* note 81 *supra* and accompanying text.

[97] 515 F.2d at 812.

[98] *Id.*

[99] *Id.*

[100] *Id.* 15 U.S.C. § 78c (1976).

[101] 515 F.2d at 812.

[102] *Id.* at 813.

[103] *Id.*

agency principles, or respondeat superior, which may be broader than the apparent authority involved here."[104]

In *Marbury Management, Inc. v. Kohn*,[105] the Court of Appeals for the Second Circuit examined the question which was left open by the *Management Dynamics* court. The *Marbury Management* court held a brokerage firm liable under the doctrine of respondeat superior for the fraudulent misrepresentations of a broker trainee.[106] By holding the corporation liable for the broker trainee's conduct, the court indicated a willingness to extend secondary liability to a brokerage firm for any 10b-5 violations. The court stated that when respondeat superior is applied to impose liability, the good faith defense afforded by section 20(a) is simply unavailable.[107] The court further stated that there is no reason to believe that Congress intended to narrow the remedies available for violations of the securities acts, or to create a novel defense in cases governed by agency principles.[108] In support of this view, the court pointed to section 28(a) of the Securities Exchange Act of 1934, which specifically states that "[t]he rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity."[109]

Given this line of case law which approves the use of agency principles despite section 20(a), one might be tempted to view *Sharp* as somewhat of an aberration because it viewed the application of respondeat superior as the exception, and not the rule. This is not the case, however, because the *Sharp* court merely relied upon *Rochez II*, a prior Third Circuit opinion. The problem which arises is that *Rochez II* does not appear to be well reasoned. The *Rochez II* court relied on what it perceived to be the legislative intent behind section 20(a) to reach its conclusion that section 20(a) precludes the application of agency principles.[110] The court reasoned that "to use *respondeat superior* for imposing secondary liability would not advance the legislative purpose of the 1934 Act and in fact would also undermine the Congressional intent by emasculating section 20(a)."[111] Having

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[104] *Id.*

[105] 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 101 S. Ct. 566 (1981).

[106] *Id.* at 707.

[107] *Id.* at 716.

[108] *Id.*

[109] 15 U.S.C. § 78bb (1976). Reid v. Madison, 455 F. Supp. 1066, 1067 (E.D. Va. 1978) ("remedies provided by the Federal Securities laws are in addition to, rather than in substitution of, any other rights and remedies that may exist at law or in equity"). *See* Diamond v. Oreamundo, 301 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

[110] 527 F.2d at 885.

[111] *Id.* at 886.

said this, the court went on to imply that respondeat superior could be applied in cases involving broker-dealers.[112] In effect, after stating that Congress intended to preempt common law agency principles, the court created a supposedly narrow exception. Assuming the court's view as to legislative intent to be correct, this must be viewed as an example of judicial legislation. The court used a public policy rationale to override Congressional intent. If Congress actually did intend to preempt common law agency principles, a flat rule should be established prohibiting agency principles from applying in every situation.

Assuming, *arguendo*, that it is necessary to have an exception to the general rule prohibiting application of agency principles, the *Sharp* holding indicates that the exception has in fact engulfed the more general rule. The *Rochez II* court specifically mentioned only broker-dealer relationships when referring to situations in which agency principles should apply.[113] The *Sharp* court, however, did not hesitate to expand the exception to include accounting firms. This was a logical extension of the *Rochez II* exception. Because the *Rochez II* exception will be applied to any relationship which involves a "public trust," however, the result is that there are few situations in which respondeat superior will not be applied. The possibility of not applying the doctrine arises only in the context of the average corporation where no high fiduciary duties exist. When high-level employees violate securities laws there is no need to resort to theories of secondary liability since these persons represent the corporation and the corporation can be held primarily liable for their actions.[114] As a result, only in cases of lower-level employees will the doctrine of respondeat superior apply. Because most 10b-5 violations are not committed by low-level employees, for all practical purposes agency principles will always apply. Therefore, what the *Rochez II* and *Sharp* courts put forth as an exception has in actuality become the rule.

There are three ways in which a court could treat the issue of section 20(a) exclusivity. If the court believes that Congress intended to restrict the remedies available to plaintiffs in securities fraud cases, the court could adopt a strict rule which would not allow application of agency principles under any circumstances. Alternatively, the court could adopt the *Sharp* approach and hold that agency principles are inapplicable except in cases involving a "public trust." A court may argue that an exception is warranted because Congress could not

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[112] *Id.*
[113] *Id.*
[114] 649 F.2d at 182 n.8.

possibly have intended to limit available remedies in such cases. Finally, the court may take the *Marbury Management* approach and hold that section 20(a) and common law agency principles are not mutually exclusive.

With respect to the first possibility, such an approach would appear to be contrary to legislative intent.[115] Although it is not exactly clear what Congress intended when it enacted section 20(a), the vast majority of courts[116] and commentators[117] believe that Congress intended to expand, rather than limit the availability of remedies for violations of the securities laws. This can be inferred from section 28(a) which in essence provides that the remedies available at common law are to be preserved under the act. It is difficult to imagine a clearer indication of the intent behind the entire Securities Exchange Act of 1934 than section 28(a). Congress intended to expand available remedies so as to aid investors who were being defrauded.[118] It is also significant that no case could be found in which a court adopted a flat rule prohibiting the application of common law agency principles.

As stated above, the *Sharp* alternative also seems to be based upon a misconception of legislative intent. The *Sharp* court adopted

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[115] *See* note 76 *supra*. Ultimately, the issue is whether or not Congress intended respondeat superior *not* to apply. In Monell v. New York City Dept. of Social Serv., 436 U.S. 658 (1978), it was argued that municipalities and other local governments should be held liable under 42 U.S.C. § 1983 (1976) on a respondeat superior theory. In rejecting this argument, the court first examined the statute itself and determined that its language required a plaintiff to show causation. The Court reasoned that if causation need be shown, respondeat superior could not possibly apply. 436 U.S. at 692. Next, the Court examined the two policies behind the doctrine, namely that application of respondeat superior would advance accidents, and that the cost of such accidents should be borne by the community as a whole. *Id.* at 693-94. The Court noted that these were the justifications put forth for the Sherman Amendment, which was believed to be unconstitutional. *Id.* The Sherman Amendment to the bill, which was the precursor of section 1983, would have held a municipality liable "for damage done to the person or property of its inhabitants by *private* persons 'riotously and tumultuously assembled.' " *Id.* at 664 (quoting Cong. Globe, 42d Cong., 1st Sess., 749 (1871)).

In short, Congress believed application of respondeat superior in this context to be unconstitutional, and therefore clearly rejected the idea. Because there was a clear Congressional directive, the Court held that it could not apply respondeat superior. *Id.* at 694. With respect to section 20(a), there is no clear Congressional intent present.

[116] *E.g.*, SEC v. Management Dynamics, Inc., 515 F.2d at 812; Marbury Management, Inc. v. Kohn, 629 F.2d at 716.

[117] *N.Y.U. Note*, *supra* note 70, at 1041; *William & Mary Note*, *supra* note 74, at 718. "It is more probable that the controlling person provisions were enacted to extend liability into those agency situations where strict application of respondeat superior principles would preclude liability." *Id.*

[118] Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967).

the first approach, and then proceeded to compound its error by contravening the very intent which it attributed to Congress. The court did not even attempt to explain how it was able to carve out an exception to a rule which it claimed was mandated by Congress. In effect, the court has adopted the approach of the Second Circuit.[119]

The third approach conforms most with the legislative intent behind section 20(a) and the purpose behind the securities laws.[120] In enacting section 20(a), Congress intended to expand the remedies available for securities laws violations.[121] Furthermore, it can be argued that section 20(a) and the doctrine of respondeat superior are not always in conflict. Courts such as *Sharp* believe there is a conflict because the defenses available under section 20(a) are not available under the doctrine of respondeat superior. It must be noted, however, that when respondeat superior is applicable, the defenses in section 20(a) will often not apply. For a person to be held liable under respondeat superior, he must be an employer. If he is an employer, chances are that he will be found to be a controlling person under section 20(a). With respect to the good faith defense, it can be argued that if an employer has a duty to supervise,[122] he could not have acted in good faith. In short, it appears that in most cases there will be no conflict because the defenses in section 20(a) will not preclude liability.

A problem which arises with respect to the application of respondeat superior, however, concerns the issue of scienter. The Supreme Court has adopted a very strict standard of scienter in 10b-5 cases—one which requires an intent to deceive, manipulate, or defraud, or at a minimum, reckless conduct.[123] If a person is held liable under the doctrine of respondeat superior, it may be that he will be held liable

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[119] *See, e.g., Marbury Management.*

[120] *See* note 76 *supra.*

[121] Several commentators have suggested that cases involving private implied causes of actions for violations of the securities laws provide support for the view that respondeat superior and section 20(a) are not mutually exclusive. *E.g. William & Mary Note, supra* note 74, at 723 & n.59; *N.Y.U. Note, supra* note 70, at 1034. Courts have held that limitations found in explicit statutory provisions should not be read into implied causes of action under rule 10b-5. *E.g.*, Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Fishman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). *But see* Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970) (limitations of section 1212 incorporated into 10b-5 cause of action); Jordan Bldg. Corp. v. Boyle, O'Connor & Co., 401 F.2d 47, 51 (7th Cir. 1968) (limitation incorporated into 10b-5 cause of action).

[122] Several courts have equated lack of good faith with negligence. "Whether this alleged failure to supervise vitiates the 'good faith' defense provided under § 20(a), . . . or whether it constitutes sufficiently negligent conduct to render Lehman directly liable as a participant according to the SEC, doubtless are two different ways of phrasing the same questions." SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973).

[123] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

for conduct which is only negligent. Such a result would contravene the mandate of the Supreme Court. In view of this it is obvious that the scienter required in rule 10b-5 cases should also be applied when attempting to impose secondary liability. The *Sharp* court held that the requirement of scienter in rule 10b-5 actions did not preclude the imposition of liability under the doctrine of respondeat superior even where the employer's actions did not rise to the level of recklessness.[124] Because Cooper's & Lybrand had a duty of "careful supervision," the court did not believe that recklessness had to be shown.[125] It was enough that the tax supervisor possessed the requisite scienter.[126] It is difficult to comprehend why a duty to supervise should have any bearing on whether or not the scienter required in 10b-5 actions has been met. Indeed, a corporation should not be held to a stricter standard of liability in cases where it acts through an agent, as opposed to cases involving primary conduct.

Courts must adopt an approach to respondeat superior and section 20(a) which reflects an understanding of the legislative purpose behind section 20(a), as well as the need to protect the investing public. The *Sharp* rationale clearly does not reflect an understanding of either of these factors. It is hoped that the Supreme Court will soon resolve the conflict which exists in the various circuit courts of appeals. Until then, application of respondeat superior in securities cases will remain a muddled area of the law.

Patrick W. Foley

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[124] 649 F.2d at 193.
[125] *Id.* at 194.
[126] *Id.* at 193.