LIABILITY OF CORPORATE DIRECTORS AS "CONTROLLING PERSONS" UNDER SECTION 20(a) OF THE SECURITIES EXCHANGE ACT

I. Introduction

With the stock market crash in 1929 and the Great Depression came recognition of the necessity for a system of nation-wide regulation in the securities area.[1] As a result, Congress enacted the Securities Act of 1933[2] (Securities Act) and its interrelated counterpart, the Securities Exchange Act of 1934[3] (Exchange Act). Under the provisions of these statutes,[4] particularly section 10(b) of the Exchange Act[5] and rule 10b-5,[6] promulgated by the Securities Exchange Commission pursuant to section 10(b), securities litigation in the federal courts has mushroomed.[7] This has been especially true in recent years with the advent of the consumer movement and the more prevalent use of the class action device.

Liability[8] for securities violations may be either primary or secondary.[9] While secondary liability may be imposed for securities laws violations under the common law theories of agency,[10] aiding and abetting and conspiracy,[11] both the Securities Act and the Exchange Act statutorily provide for such

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1. *See* W. Knepper, Liability of Corporate Officers and Directors § 7.01 (2d ed. 1973).

2. 15 U.S.C. §§ 77a-yyy (1976).

3. 15 U.S.C. §§ 78a-ii (1976).

4. In general, the Securities Act requires registration as a prerequisite to the sale or issuance of securities by corporations falling within its coverage and prohibits false or misleading statements; and the Exchange Act created the Securities Exchange Commission (SEC), granted it broad powers to ensure against securities fraud and provided a system of minimum standards regarding securities transactions. *See generally* Knepper, *supra* note 1.

5. 15 U.S.C. § 78j(b) (1976).

6. 17 C.F.R. § 240.10b-5 (1977).

7. *See* 1 A. Bromberg, Securities Law: Fraud: SEC Rule 10b-5 § 2.5(6), at 45-46 (1977).

8. Both the Securities Act and the Exchange Act impose criminal liability and expressly provide for civil recovery under certain provisions. There is an implied right of private action for 10b-5 violations, and implied civil liability has also been extended for violations of other provisions. *See* Bromberg, *supra* note 7, § 2.4(1), at 27-28.

9. Unlike primary liability, which is predicated on direct participation in the illegal act, secondary liability is based upon the general principle that parties in a position to have exercised control over or prevented the unlawful acts of others should be held legally responsible for such acts.

10. *See, e.g.,* SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied,* 409 U.S. 880 (1972); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part and rev'd in part,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916 (1974).

11. *See, e.g.,* Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969). *See also* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. Pa. L. Rev. 597 (1972). For a discussion of the various theories of secondary liability of controlling persons in the securities laws context, see Note, *Liability of Controlling Persons - Common Law and Statutory Theories of Secondary Liability,* 24 Drake L. Rev. 621 (1975) [hereinafter cited as Drake Note].

liability with regard to "controlling persons."[12] Section 15 of the Securities Act[13] and section 20 of the Exchange Act[14] impose liability upon persons for the unlawful acts of those primary defendants who are within their control. This concept of "control" is the underlying basis in the applicable provisions of both the Securities Act[15] and the Exchange Act[16] for the imposition of secondary liability.

Section 20 of the Exchange Act provides in pertinent part as follows:

> (a) 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.[17]

Thus, the statutory doctrine of controlling persons, as set forth in section 20(a), features three major elements: 1) a primary violation of the Exchange Act; 2) the control of the primary defendant by another person; and 3) the availability of the statutory "good faith" defense to one determined to have been in control. The burden is on the complaining party to establish that the defendant was in fact in control of the primary violator.[18] Once control has been established, the burden then shifts to the defendant to prove that he "acted in good faith and did not directly or indirectly induce the act or acts

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12. The "controlling persons" statutory provisions are not limited by the traditional doctrines of agency and conspiracy. *See* Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101, 104 (D. Del. 1974).

13. 15 U.S.C. § 77o (1976).

14. 15 U.S.C. § 78t (1976).

15. Section 15 of the Securities Act provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 66k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1976).

16. *See* note 17 *infra* & accompanying text.

17. 15 U.S.C. § 78t(a) (1976). Section 20 of the Exchange Act also provides:

> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.
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> (c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information.

15 U.S.C. § 78t(b), (c) (1976).

18. Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977). However, in *Stern* the court indicated that it was not necessary to allege that there was an actual exercise of control or make factual allegations showing control. *Id.* at 824.

constituting the violation or cause of action."[19]

For the corporate director, the massive amount of litigation under the securities laws is undoubtedly an area of concern.[20] With increasing frequency, persons of directorial status have found themselves named as defendants in securities litigation. Thus, the importance of section 20(a) of the Exchange Act with regard to directors is obvious. In addition to the prolific litigation in the securities area,[21] the trend toward increasing demands of accountability from directors[22] and the further fact that in many instances the corporation and primary defendants are insolvent or unavailable[23] are also factors making the director a natural target for claims of damages based on securities violations. The purpose of this Note is to examine the status of corporate directors as controlling persons under section 20(a) through the consideration of two major issues: 1) the activities of a director which will be sufficient to constitute being deemed in control of a primary defendant; and 2) the scope of the knowledge or scienter requirement with regard to the statutory good faith defense.

II. Control

The concept of control,[24] in the context of the securities laws, is an elusive notion for which no clear-cut rule or standard has been devised.[25] In some situations, *e.g.*, where the party owns ninety percent of the corporation's stock and personally makes corporate management and policy decisions, the

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19. 15 U.S.C. § 78t(a) (1976). *See* Stern v. American Bankshares Corp., 429 F. Supp. 818, 823 (E.D. Wis. 1977).

20. *See, e.g.*, Knepper, *Let the Director Beware*, 37 Ins. Counsel J. 27, 27 (1970).

21. The vast amount of securities litigation predicated on rule 10b-5 in particular makes section 20(a) an important source of potential liability.

22. Several factors have been cited as being the sources of the modern reappraisal of directors' responsibilities. Among these are the following:

> The apparent loss of public confidence in institutions in general and in business in particular.
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> The growth of "social consciousness" in recent years as reflected in new federal and state laws and regulations concerning environmental matters, equal employment opportunity, product and worker safety, and employee pension protection.
>
> Highly publicized cases and consent decrees involving alleged violations of federal securities laws.
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> The "Watergate" revelations and the disclosures of illegal and questionable payments by many corporations.

3 Corporate Practice Series A-1 (BNA) (1976). *See also* Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability under the Federal Securities Laws*, 1972 Duke L. J. 1153, 1154-55.

23. *See, e.g.*, Holloway v. Howerdd, 377 F. Supp. 754, 759 (M.D. Tenn. 1973), *aff'd in pertinent part*, 536 F.2d 690 (6th Cir. 1976) (corporation was bankrupt and many of the primary defendants were deceased).

24. For an earlier discussion of control in the general context of section 20(a), see 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 (1973) [hereinafter cited as N.Y.U. Note].

25. *See* Sommer, *Who's "In Control"? - S.E.C.*, 21 Bus. Law. 559, 563 (1966).

determination is easily made. However, in the majority of cases the presence of control is much more subtle, necessitating an examination of a variety of factors before a proper conclusion may be drawn.[26]

With regard to corporate directors, the problem of which characteristics or combinations of characteristics will be sufficient to constitute control for purposes of section 20(a) is of special significance due to the many different permutations of directorial traits possible. A few of the numerous director "types" are: inside directors - persons who are high-ranking executive officers or even corporate presidents, directors who are majority shareholders, outside directors, directors who take a regular and active role in corporate affairs and directors who are basically inactive in corporate matters. The focal question thus becomes: which of the various descriptions and characteristics, or combinations thereof, will lead to a director's inclusion within the statutory concept of controlling persons.

A. *Statutory Materials*

Neither section 20(a) nor the other provisions of the securities laws provide a definition of control. It appears to have been Congress' intent to leave this term without an explicit definition. The legislative history indicates not only congressional awareness of the inability to provide a definition which would cover the many possible types of control but also the intent to keep the concept an adaptable one.[27]

The Securities Exchange Commission has defined control in the following manner:[28] "The term 'control' (including the terms 'controlling', 'controlled by' and 'under common control with') 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."[29] This definition provides a description

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26. *Id.*

27. The House Report supports this conclusion:

> 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 [sic] 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 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 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). Handy & Harman v. Burnet, 284 U.S. 136 (1931), the case to which the House Report referred, dealt with the question of whether two corporations were controlled by the same interests for purposes of a provision of the Internal Revenue Code. The Court recognized that control of a corporation could be legally enforceable control (ownership) or "actual" control (some means other than ownership). 284 U.S. at 140.

28. While this definition specifically pertains to registration and qualification, it nevertheless offers some help in attempting to define "control" as that term is generally utilized in the context of secondary liability.

29. 17 C.F.R. § 240.12b-2(f) (1978).

of some of the aspects of control as used in the securities context: it is a power, which may be possessed either directly or indirectly, to cause the direction of the management and policies of a person or a corporation.[30] Further, this power may be held through means other than simply the ownership of voting stock in the corporation.[31] This definition, however, standing alone, provides only the basic framework of the concept of control and does not sufficiently answer the question of which directorial activities and characteristics will be sufficient to permit a determination that a particular director was in control.

Thus, while these statutory and regulatory materials indicate the intended flexible nature of the control concept and some of its basic elements, examination of the appropriate case law becomes necessary to ascertain the specific boundaries of directorial control.

B. *Judicial and Administrative Decisions*

Examination of the relevant judicial and administrative (SEC) decisions dealing with the question of directorial control under section 20(a) reveals no single accepted standard.[32] However, the majority of the cases do reflect the apparent congressional intent that the concept be broad and flexible: "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."[33] Furthermore, the decisions also provide an outline of those directorial characteristics generally considered sufficient to label a particular defendant-director a controlling person.

One factor which the majority of cases agree upon is that of ownership. While ownership of a large percentage of stock would in most cases constitute highly persuasive evidence of control of a corporation,[34] it is generally held that the means of control need not be stock ownership.[35] For example, in *Klapmeier v. Telecheck International, Inc.*,[36] an action was brought by shareholders of Boatel, Inc. alleging securities violations arising out of a merger

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30. Sommer, *supra* note 25, at 564.

31. *See* text accompanying notes 34-41 *infra*.

32. *Compare* Dyer v. E. Trust and Banking Co., 336 F.Supp. 890 (D. Me. 1971) *and* Moerman v. Zipco, Inc., 302 F.Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 442 F.2d 871 (2d Cir. 1970) *with* Stern v. American Bankshares, Corp., 429 F.Supp. 818 (E.D. Wis. 1977) *and* Holloway v. Howerdd, 377 F.Supp. 754 (M.D. Tenn. 1973), *aff'd in pertinent part*, 536 F.2d 690 (6th Cir. 1976). *See* text accompanying notes 40-50 *infra*.

33. Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). The quoted material is often cited by courts examining judicial interpretations of section 20(a).

34. *See, e.g.*, Mader v. Armel, 461 F.2d 1123, 1126 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972). In *Mader*, a director of a corporation who, with his family, had invested heavily in that corporation, was found to be a controlling person in an action based upon a fraudulent proxy solicitation. The extent of his investment in the company was indicative of his status as a controlling person. *See also* Sommers, *supra* note 25, at 567-72.

35. *See* Klapmeier v. Telecheck Int'l, Inc., 315 F. Supp. 1360 (D. Minn. 1970), *rev'd and remanded on other grounds*, 482 F.2d 247 (8th Cir. 1973). *See also* Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101 (D. Del. 1974).

36. 315 F. Supp. 1360 (D. Minn. 1970), *rev'd and remanded on other grounds*, 482 F.2d 247 (8th Cir. 1973).

between Boatel and Telecheck, the primary defendant. At the pre-trial stage, several of the secondary defendants moved to dismiss the action for lack of personal jurisdiction on the ground that they were not controlling persons within the meaning of the securities laws. The court, in refusing to grant this motion on the basis of insufficient evidence, stated: "While a majority shareholder might as a matter of law be held to 'control' the entity regardless of his actual participation in management decisions and the specific transaction in question, the absence of a substantial ownership of shares does not foreclose liability under the Act as a 'controlling person.' "[37] On appeal, the Eighth Circuit did not challenge this statement in evaluating the lower court's determination that Kerr, one of the defendants, was a controlling person. The facts in the lower court record indicated that Kerr had served on both the board of directors and executive committee of Telecheck, had been the secretary of Telecheck and one of its subsidiaries and had been a participant in the merger from which the case arose. While not specifically speaking to the question of ownership, the appellate court did sustain the jury determination that Kerr was a controlling person, holding that the above facts constituted a sufficient basis to support a finding that he had exercised some influence over Telecheck.[38]

The position taken with regard to ownership in *Klapmeier* is representative of the realistic view that stock ownership is not a prerequisite to corporate control[39] and leaves open the potential imposition of controlling persons liability on parties, *i.e.*, certain directors and officers, who are able to control corporate operations and policy without an ownership interest therein. Further, this approach is consistent with the remedial nature of the statute and the congressional intent to keep the definition of control an adaptable and flexible concept.[40] This reading is also consistent with the definition of "control" promulgated by the SEC.[41] Thus, while a director's ownership of more than an insubstantial amount of a corporation's stock would be a factor indicative of control, such ownership is not a necessity, and non-owner directors cannot expect to avoid controlling persons status on this ground alone when other indices of control are present.

Further examination of the applicable case law reveals an area in which some disagreement exists among courts: the issue of whether status as a director alone is sufficient to presume or warrant a finding of control.[42] One

37. *Id.* at 1361.

38. 482 F.2d at 256.

39. The "divorce" of control and ownership in the corporate context is an oft-commented upon phenomenon. Control of a corporation may be achieved through several means other than ownership, including various legal devices and management control, which are most relevant in the context of statutory secondary liability. *See* A. BEARLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69-88 (rev. ed. 1968).

40. *See* text accompanying notes 27-31 *supra*.

41. 17 C.F.R. § 240.12b-2(f) (1978). *See* text accompanying notes 28-31 *supra*.

42. For other discussions of the judicial imposition of a finding of control based on a defendant's status as a director or officer, see DRAKE NOTE, *supra* note 11; N.Y.U. NOTE, *supra* note 24 (terming this the "control-by-status" approach).

line of cases has held that once it is established that a particular defendant occupied the position of director at the time of the events in question, regardless of the extent of his participation in corporate decision-making, this fact in and of itself will be enough to support a determination that such defendant was in control.[43]

An example of this "control-by-status" approach is *Moerman v. Zipco, Inc.*,[44] in which an action was instituted for violations of rule 10b-5 stemming from the issuance of shares of Zipco, Inc. In determining that controlling persons status should be imposed upon certain defendants, directors of Zipco, the court stated: "The conclusion is inescapable that persons who act as directors are in control of the corporation. This is especially true in light of the liberal construction of this section as including 'indirect means of discipline or influence short of actual direction.' "[45] Although the testimony in *Moerman* indicated that the particular defendant-directors had been active participants in corporate affairs, the extent of participation in the management of the corporation is initially unimportant under this approach since the threshold determination of whether a particular defendant is in control for purposes of the statute is apparently based solely on status as a director. However, as will later be discussed,[46] the degree of participation and any other facts tending to show that the director is nonculpable are still of importance insofar as the defendant may avoid the imposition of liability via the good faith defense. Thus, in *Moerman*, the secondary defendants did avoid the imposition of liability despite having been found to be controlling persons by virtue of their director status because they were apparently unaware of the fraudulent activities of the corporation's president with regard to the illegal stock issuance and could not have been expected to have supervised his activities more closely.[47]

While a few cases have utilized the control-by-status approach, the trend of decisions appears to indicate that the courts generally are more likely to consider the entire factual context of a particular case, *i.e.*, the extent of participation in corporate management and policymaking; length and period of time spent as a director; extent of ownership in the corporation, if any; and all other relevant circumstances.[48] Thus, whether control exists in any given situation has been treated as a question of fact by most courts, and control has not been automatically presumed from a defendant's status as a director.

While it may be true that the control-by-status approach is consistent

43. *See* Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890, 915 (D. Me. 1971) (director *prima facie* a controlling person for purposes of § 15 of the Securities Act); Moerman v. Zipco, Inc., 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

44. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

45. *Id.* at 447 (citing Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968)).

46. The statutory good faith defense is discussed in section III of the text *infra*.

47. 302 F. Supp. at 447.

48. Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977); Holloway v. Howerdd, 377 F. Supp. 754 (M.D. Tenn. 1973), *aff'd in pertinent part*, 536 F.2d 690 (6th Cir. 1976).

with the remedial nature of section 20(a),[49] there are several arguments against basing this threshold determination on position alone. First, status as a corporate director, as a practical matter, in many cases does not automatically mean that such a person is actually in a position to exercise control over the corporation and its officers and employees.[50] This is particularly true of outside directors, who are under time constraints (the average corporate board generally meets at a maximum of once a month)[51] and often do not have access to information which would be necessary to take a more active role in the management of corporate affairs.[52] Furthermore, in many instances directors are to a large degree dependent upon executive corporate management, often rendering the board of directors nothing more than a "rubber-stamp."[53] In light of the above factors, it is clear that in many situations status as a corporate director will not necessarily place a person in a position of control. Thus, to base the determination of control for purposes of section 20(a) liability solely on a party's directorial position may in some cases lead to an unrealistic result.

An additional argument against the control-by-status approach is that it is meaningless in terms of reaching a result different from the "totality of the facts" approach. That is, as noted earlier,[54] even in cases in which the presence of control is determined solely on the basis of status, factors indicating that the director really did not have control over the primary violator will be material to the assertion of the good faith defense and therefore will still affect the overall determination of secondary liability. Thus, while the results will probably be the same under either method of analysis, treatment of the existence of control as a question of fact based upon all the relevant circumstances seems the more forthright alternative.

Yet another argument against the control-by-status approach is that it comes too close to the imposition of strict liability upon directors for those acts of their subordinates which are violative of the securities laws. While it is technically untrue that this approach imposes strict liability, due to the

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49. *See* N.Y.U. NOTE, *supra* note 24, at 1022.

50. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION - A LEGAL ANALYSIS 139-48 (1976).

51. *Id.* at 141.

52. *Id.*

53. This view of the modern corporate board of directors differs substantially from the theoretical corporate structure wherein the board of directors manages the corporation and determines its policies. However, it offers a much more realistic picture of actual board practice. Board dependency on corporate management stems not only from the constraints of time and information, but also from the fact that in many instances board members are either psychologically or economically tied to corporate executives. Corporate employees who double as directors will be extremely unlikely to depart from the view taken by management at board meetings. In addition, many outside directors are lawyers, investment bankers or others who supply services to the corporation. It is unlikely that they will risk losing the corporation as a client by taking a position adverse to that advocated by its chief executive and management, who generally control the purchase of such services. Finally, directors are often tied to management simply through friendship or similar informal means. *Id.* at 139-48.

54. *See* text accompanying notes 46 & 47 *supra*.

availability of the statutory good faith defense, the argument can nevertheless be made that the high risk of personal liability which might result from the operation of this approach serves to "scare away" qualified potential directors who are favored by both management and shareholders and who otherwise would have been available for service. Although this may seem a somewhat tenuous argument, it is a plausible one, particularly should the control-by-status approach be utilized on a wide scale.

A final criticism of this method of analysis is that, although it may be consistent with the remedial nature of section 20(a), it nonetheless makes control a static concept, contrary to the congressional intent to keep it a flexible one.

These arguments against the "control-by-status" approach, particularly the first, indicate that basing a determination of control on a person's status as a director alone can often lead to unrealistic and potentially undesirable results. As noted, most courts do not adhere to the "control-by-status" rationale; instead, they treat the question of control as one to be answered from the facts of the particular case.[55] A good theoretical framework for the "fact approach" to the determination of section 20(a) control was set forth in *Stern v. American Bankshares Corp.*[56] In *Stern*, the court formulated an analysis which prescribed two threshold requirements to be satisfied by the complaining party: 1) the alleged controlling person must have been an *active participant* in the operations of the particular corporation; and 2) the alleged controlling person must have possessed actual control over the *transaction* which gave rise to the primary securities violation.[57] This two-pronged analysis delineates the elements which have been emphasized in the majority of the cases which have treated the question of control as a factual one. While these elements are highly interrelated, the second, possession of actual control over the allegedly unlawful transaction, is usually the more decisive.

It is important to note that there is a distinction between the power to control and the actual exercise of such power with respect to an underlying unlawful transaction.[58] The *power* to control has been the focus of most cases in this context.[59] In *Rochez Bros. v. Rhoades*,[60] the Third Circuit Court of Appeals stated that "the courts have given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof."[61] Thus, a director could under some

55. *See* Camrose, Inc. v. Intervestor U.S. Real Estate Fund, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,469 (S.D.N.Y. 1976); Klapmeier v. Telecheck Int'l, Inc., 315 F. Supp. 1360 (D. Minn. 1970), *rev'd and remanded on other grounds*, 482 F.2d 247 (8th Cir. 1973).

56. 429 F. Supp. 818 (E.D. Wis. 1977).

57. *Id.* at 824.

58. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101, 105 (D. Del. 1974). *See also* Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977).

59. *See* Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101 (D. Del. 1974).

60. 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976).

61. *Id.* at 890-91. Note that this position is consistent with the remedial nature of section 20(a).

circumstances be found to be a controlling person even where there was *no exercise* of control in connection with the underlying violative transaction, as long a it was established that he had the *power* to exercise such control.[62]

If the facts, beyond mere status as a director, indicate that the ability to control the transaction in question was present, then a determination that the particular party was a controlling person may properly be made. However, such a determination does not automatically mean that liability will be imposed. Rather, it raises questions as to the existence of culpable inaction or the extent of the defendant's knowledge with respect to the underlying violation, factors to be considered in the overall determination of liability via the statutory good faith defense.[63]

The conclusion that a particular director-defendant did have the power to control a primary defendant may stem from various characteristics considered during the examination of the factual context of the case. Of these, probably the most indicative of the power to control is participation in corporate operations, the other element of the two-part analysis enunciated in *Stern*. In *Holloway v. Howerdd,*[64] a case which involved securities violations[65] in the sale of stock of a particular corporation, the court discussed the necessity of establishing that a director was an active participant in corporate affairs before a finding of control could be made, and shed some light on what would be considered "active participation":

> The court accepts as settled law the proposition that directors of a corporation may be found liable as controlling persons, both under the Securities Act and the Exchange Act, even without actively participating in the conduct upon which liability is founded. [citations omitted].
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> Nevertheless, a director's liability, pretermitting the good faith defense of § 78t, presupposes some extent of actual participation in the corporation's operation before the consequences of control may be imposed . . . . Regardless of what may in general suffice as active participa-

62. *See* Holloway v. Howerdd, 377 F. Supp. 754, 761 (M.D. Tenn. 1973), *aff'd in pertinent part,* 536 F.2d 690 (6th Cir. 1976): "The court accepts as settled law the proposition that directors of a corporation may be found liable as controlling persons, both under the Securities Act and the Exchange Act, even without actively participating in the conduct upon which liability is founded."

63. *See* Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101 (D. Del. 1974). There, in evaluating the status of a corporate defendant as a controlling person, the court stated:

> Under Section 20(a) the participation of a controlling person in the transaction of which plaintiffs complain is not relevant to liability except insofar as the defendant may demonstrate, by way of defense, that he did not, "directly or indirectly induce" that transaction. And, since one may be a controlling person without having in fact exercised control, a plaintiff can state a cause of action under Sections 10b-5 and 20(a) of the Act without alleging any affirmative action on the part of the defendant.

Id. at 105.

64. 377 F. Supp. 754 (M.D. Tenn. 1973), *aff'd in pertinent part,* 536 F.2d 690 (6th Cir. 1976).

65. *Holloway* involved a class action suit which alleged violations of sections 5, 12 and 17 of the Securities Act, section 10(b) of the Exchange Act and SEC rule 10b-5 in connection with a scheme to sell worthless stock before and after incorporation. *Id.* at 756.

> tion, the court feels that at a minimum, persons sought to be charged with control must occupy a director's position at times material to the litigation, and act in a manner which directly or indirectly influences the purchase of securities.[66]

Using these criteria, the court determined that Howerdd, named as a secondary defendant, was not a controlling person with respect to the actions of the corporation and its employees. The facts indicated that Howerdd had actually served as a director for less than a month and in only a temporary capacity.[67] Finding no proof indicative of control, the court concluded that he had never exercised any degree of control over the corporation or its employees at any time.[68] Thus, it appears that "active participation in corporate operations" by the corporate director at a minimum requires participation in board meetings and other management functions.[69]

A further indice of the power to control is the length and particular time period of the director's tenure. As noted in *Holloway*, at a minimum it is required that the party allegedly in control have occupied the position of director during the time material to the litigation. One example of the treatment of time of tenure as a relevant factor may be found in *Mader v. Armel.*[70] In *Mader*, a director who had been associated with the corporation for less than a year, and who had never attended or had reason to attend a board meeting until twelve days prior to the commission of the securities violation, was held not to be a controlling person.[71]

It should also be noted that a director charged with control need not possess the power to directly control the primary defendants; rather, all that is necessary is the ability to indirectly control or influence the primary offenders.[72] Therefore, all factors relevant to the overall relationship between the director and such parties should be taken into consideration in determining whether control was present.

From this examination of the relevant case law, it appears that these general guidelines can be drawn on the issue of "control" with regard to corporate directors:

> (1) as a general statement, nonownership of stock in a corporation will not bar a finding of control; however, ownership by a director will be a factor indicative of control;
>
> (2) status as a director in some cases is sufficient to raise a presumption of control (rebuttable via the statutory good faith

66. *Id.* at 761.

67. *Id.* at 761-62.

68. *Id.* at 762-63.

69. Accordingly, it has been held that the inactive director, *i.e.*, one who is uninvolved in the business of the corporation, absent a showing of some other means of involvement, will not be considered a controlling person under section 20(a). Camrose, Inc. v. Intervestor U.S. Real Estate Fund, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,469 (S.D.N.Y. 1976).

70. 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).

71. *Id.* at 1125.

72. *See* Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

defense); however, in most cases the fact that the party charged occupies such a position is simply one of many factors to be considered and does not in and of itself carry a great deal of weight;

(3) most cases treat the issue of control as a complex factual question and generally require that the director charged have the power to exercise control over the primary defendants; in determining whether this power is present, consideration is given to the extent of participation in corporate management functions (the greater the degree of active participation, the stronger the inference of control), the length of time spent as a director, formal and informal relationships between the parties and any other material factors present in the particular case.

While no hard and fast rule can be derived, these general guidelines will provide some indication of when a director will be considered a controlling person under section 20(a).

III. The Statutory Good Faith Defense

The question of liability under section 20(a) does not end with a determination that the defendant was a controlling person. Even though control is established, the defendant may nonetheless escape the imposition of secondary liability by showing that he acted in good faith and did not directly or indirectly induce the violative act. The scope of this statutory defense is somewhat unclear, due mainly to the fact that the ultimate disposition of the issue of good faith necessarily depends on the extent to which the particular secondary defendant was knowledgeable of his subordinate's unlawful acts.[73]

It has been stated that "those who neither know nor have reason to know" of the violative acts of a subordinate will not incur liability as controlling persons.[74] In *Lanza v. Drexel & Co.*,[75] the claim of good faith asserted by the president-director of a corporation was found to be insufficient where the facts indicated that he was aware that his subordinates were preparing false information for use in press releases and that they were responsible for misleading statements in earlier documents.[76] Actual knowledge of the underlying violative act as it occurs, then, is clearly sufficient to preclude application of the good faith defense. However, major questions arise with respect to constructive knowledge and the circumstances under which it will be deemed present. In analyzing the issue of constructive knowledge, it is necessary to consider the duty of inquiry to be imposed upon a director and whether this duty was fulfilled. In other words, the issue is what degree of inquiry into corporate affairs by a director, determined to be a controlling person, is necessary to establish good faith.

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73. *See* Ingenito v. Bermec Corp., 441 F. Supp. 525, 533 (S.D.N.Y. 1977).

74. *Id.* (citing Lanza v. Drexel & Co., 479 F.2d 1277, 1300-04 (2d Cir. 1974)).

75. [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826 (S.D.N.Y. 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973).

76. *Id.* at 90,103.

One means of approaching the issue of duty and constructive knowledge is to focus on the extent of internal corporate supervision, *i.e.*, "whether adequate mechanisms were established to discover and prevent the alleged fraud."[77] Most cases examining this question have dealt with broker-dealers as secondary defendants, the consensus being that a showing of a "reasonable and proper" system of internal supervision over subordinates directed toward the prevention of securities violations is necessary in order for such persons to establish the good faith defense.[78] What constitutes "reasonable and proper" supervision will be dependent upon the facts of the particular case.[79]

The decisions create a dichotomy and indicate that corporate directors owe a lesser duty of supervision than broker-dealers. For example, in *Moerman v. Zipco, Inc.*,[80] while evaluating the sufficiency of the good faith defense of a director found to have been a controlling person with respect to the primary defendant, a corporate officer, the court stated: "Directors cannot be expected to exercise the kind of supervision over a corporate president that brokers must exercise over salesmen."[81] It appears that this viewpoint is a realistic one, indicative of the fact that most directors, particularly those who do not double as a part of the corporate management structure, are under both time and information constraints,[82] making it exceedingly difficult for such persons to exercise the same degree of supervision as would broker-dealers.[83] Further support for holding directors to a less stringent standard can be found in the argument that imposition of a higher supervisory obligation would lead to difficulty in the recruitment of qualified persons for positions as directors, thus resulting in less net benefit to the corporation and shareholders than would obtain under a less stringent standard.[84] Finally, it seems that broker-dealers should be held to a higher duty of supervision with respect to their subordinates, mainly salesmen, since they are involved in securities dealings with the public to a much greater extent than the average

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77. Ingenito v. Bermec Corp., 441 F. Supp. 525, 533 (S.D.N.Y. 1977).

78. Zweig v. Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); Gordon v. Burr, 366 F. Supp. 156, 168 (S.D.N.Y. 1973), *aff'd in part and rev'd in part on other grounds*, 506 F.2d 1080 (2d Cir. 1974).

79. *See, e.g.*, SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) (failure to maintain proper supervisory system found where corporation allowed its president, the primary violator, to enforce a rule preventing others from opening mail addressed to the corporation but marked for his attention; liability here was also predicated on an aiding and abetting theory); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973)(broker-dealer's implementation of supervisory system, albeit ineffective, was enough to establish the good faith defense).

80. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

81. *Id.* at 447.

82. *See* Eisenberg, *supra* note 50, at 139-44.

83. This is not to suggest that outside directors should not play a more active role in corporate management. For a brief discussion of suggested reforms of the corporate board situation, see Eisenberg, *supra* note 50, at 149-56.

84. *See* Lanza v. Drexel & Co., [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826 (S.D.N.Y. 1970), *aff'd*, 479 F.2d 1277, 1307 (2d Cir. 1973).

corporate director.[85] Because the possibility of securities laws violations by broker-dealers' subordinates is greater, the more stringent standard for broker-dealers appears to be warranted.

The determination that corporate directors will not be held to as stringent a standard of inquiry and supervision with respect to subordinates as are broker-dealers does not completely resolve the question of duty, however. Further delineation of the duty of inquiry expected of directors is dependent upon the methodology utilized in determining the propriety of imposing secondary liability upon a director who has failed to discover or act to remedy unlawful acts of subordinates. The prevalent approach to this issue is based upon the concepts of scienter and negligence.[86]

One of the leading cases analyzing the secondary liability of directors in terms of the scienter-negligence requirement is *Lanza v. Drexel & Co.*[87] *Lanza* involved a private exchange of the stock of two corporations, one of which filed for bankruptcy a year later. The action alleged that former officers and directors of the bankrupt corporation had misled the plaintiffs through material misstatements and omissions with respect to the corporation's financial condition at the time of the transaction. The major issue dealt with by the Second Circuit in *Lanza* was the secondary liability of Coleman, an outside director, for violations of rule 10b-5 committed by officers and other directors of the corporation. Specifically, the court considered the extent to which the rule imposed an obligation upon parties other than the primary defendants to ensure that prospective purchasers of corporate stock received all pertinent information concerning the transaction. The record indicated that while Coleman had known of the transaction with the plaintiffs, he had not been a participant and was unaware of the true financial condition of the corporation and the fact that the plaintiffs had been misled. He had been aware, however, of "many disquieting facts" about the corporation, "particularly certain adverse financial developments and the making of misleading statements to the financial community" by some of its officers.[88] After a thorough examination, the majority concluded that "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."[89] Since Coleman owed no duty as a director under rule 10b-5 to insure that all relevant information was given to the purchasers, and because he was not involved in the transaction as an

85. *See* Kravitz v. Pressman, Frohlich & Frost, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,331, at 93,107-08 (D. Mass. 1978).

86. "Scienter" has traditionally meant "intent to deceive." For a discussion of the concept of scienter in the securities context, see H. BLOOMENTHAL, 3A SECURITIES AND FEDERAL CORPORATE LAW, § 9.21(4) (1978).

87. 479 F.2d 1277 (2d Cir. 1973).

88. *Id.* at 1304.

89. *Id.* at 1289.

aider and abettor, conspirator or substantial participant, the lower court's dismissal of the complaint as against him was held to be proper.[90] The fact that Coleman's actions were negligent was not, in the court's opinion, a sufficient basis upon which to predicate liability; rather, the standard to be utilized required proof of a "willful or reckless disregard for the truth" before liability could properly be imposed.[91]

While this analysis in *Lanza* was in terms of implied secondary liability for violations of rule 10b-5, it would also be appropriate in terms of section 20(a) secondary liability.[92] The court in *Lanza* stated that the congressional intent in passing that section "was obviously to impose liability only on those directors who fall within its definition of control *and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.*"[93] Thus, before liability under section 20(a) could be imposed, evidence of scienter or at least reckless disregard for the truth would be necessary.

Two dissenting opinions were filed in the *Lanza* case with respect to the scienter-negligence issue.[94] In one, Judge Hays stressed that the standard employed by the majority was inappropriate; he felt that Coleman, in his position as a director, should have taken steps to better acquaint himself with the transaction in question: "That Coleman's failure to act was negligent as opposed to calculated should not insulate him from liability when action on his part might have prevented the fraud perpetrated by the corporation whose activities he was under a duty to supervise."[95] Thus, Judge Hays was of the opinion that proof of scienter, or at least recklessness, was not a necessary element in a 10b-5 action and, therefore, Coleman could be held secondarily liable on the basis of his negligent failure to keep himself adequately informed, his duty as a director.[96] Pro Hocke

The rationale of the majority in *Lanza,* then, as applies to section 20(a), is that "some meaningful sense of culpability," *i.e.,* scienter or at least reckless disregard, is required before there can be any imposition of secondary

90. The majority in *Lanza* concluded that secondary liability for violations of rule 10b-5 could be imposed only on defendants who were either aiders and abettors, conspirators or substantial participants in the fraud perpetrated by others. *Id.*

91. *Id.* at 1306.

92. *See* BLOOMENTHAL, *supra* note 86, § 8.25A, at 8-74.

93. 479 F.2d at 1299 (emphasis added).

94. Both opinions dissented with respect to the majority's determination of the scienter issue and concurred in regard to a second question, the propriety of the denial of another defendant's request for a jury trial.

95. *Id.* at 1319 (Hays, J., concurring in part and dissenting in part).

96. *Id.* In the second dissenting opinion, Judge Timbers indicated that the facts were sufficient to show that Coleman had acted recklessly; therefore there was no reason to reach the question of whether secondary liability could properly be predicated in this context upon negligence alone. *Id.* at 1320 (Timbers, J., concurring in part and dissenting in part). His opinion also seemed to imply that the standard of care required of a director might be higher in cases where, as here, the particular director was experienced in sophisticated financial and business matters and was serving as a director in part to protect the economic interests of the corporation's investment banker. *Id.* at 1320-21 (Timbers, J., concurring in part and dissenting in part).

liability. One result of this culpability approach is to impose only a minimal duty of supervision on corporate directors. Outside directors have no affirmative duty to become informed with respect to operations and transactions involving the stock of the corporation on whose board they sit. Nor does predicating liability on the basis of a secondary defendant's recklessness broaden the duty to any significant extent.[97] This would seemingly result in the imposition of liability only in situations where the particular director-defendant blatantly ignored facts surrounding a fraudulent transaction and gave it his approval. At least one commentator has offered criticism of the limited duty required of directors under the *Lanza* rationale:

> The unfortunate aspect of *Lanza* is that largely on doctrinaire grounds it adopted a standard for many directors which insofar as the securities laws are concerned encourages neglect of their duty as a director to remain informed and to provide a degree of supervision and guidance to insiders. The less a director knows and the less he participates in corporate affairs the less responsibility he will have in all areas other than with respect to a securities registration statement.[98]

This concern appears to be a valid one, balanced as it is against the interest in avoiding the imposition of too stringent a duty of supervision upon outside directors.[99] However, it seems that both these interests could be furthered through the adoption of a means of analysis which would not be limited by labels such as scienter, recklessness and negligence, that is, a sliding-scale approach which would take into consideration all relevant factors in determining the appropriate duty to be imposed upon any particular defendant.[100]

A sliding-scale approach to the problem of duty in the context of the securities laws was proposed by the Ninth Circuit Court of Appeals in *White*

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97. The United States Supreme Court, in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), adopted the approach taken by the Second Circuit in *Lanza*, holding that proof of scienter is necessary before liability may be imposed on an alleged aider and abettor under § 10(b) and rule 10b-5. *Id.* at 193. In making this determination, however, the Court left open the question of whether recklessness would be sufficient to satisfy this scienter requirement. *Id.* at 194 n.12. Thus, the *Lanza* court's determination that secondary liability might properly be imposed in cases where reckless disregard for the truth is shown, although not expressly reiterated in *Hochfelder*, would still appear to retain vitality. Also, a later Second Circuit decision, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 47 U.S.L.W. 3391 (U.S. Dec. 4, 1978), specifically addressed this issue with respect to the secondary liability (aiding and abetting) of a broker-dealer defendant. The court concluded that at least in situations where the alleged aider and abettor owed a fiduciary duty to the injured party, recklessness would satisfy the scienter requirement. *Id.* at 44. For a discussion of the concept of "scienter" in the context of rule 10b-5 and the *Hochfelder* case, see Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 Stan. L. Rev. 213 (1977).

98. Bloomenthal, *supra* note 86, § 8.25A, at 8-74.5.

99. *See* note 84 & accompanying text *supra*.

100. *See* Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. Rev. 1206 (1970). *See also* White v. Abrams, 495 F.2d 724, 734-35 (9th Cir. 1974).

v. Abrams,[101] in determining the appropriate standard of care imposed by rule 10b-5. The court described its proposed "flexible duty standard" as follows:

> The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify . . . . This flexible approach, as compared with the compartmentalized approach, does away with the necessity of creating a separate pigeon hole for each defendant whose involvement in the transaction in question may not fit nicely into one of the previously defined classes.[102]

While the particular issue addressed by the court in *Abrams* was the extent of the duty imposed by rule 10b-5, it nevertheless seems that this flexible duty standard could be utilized with favorable results in the context of section 20(a). Rather than making the analysis strictly on the basis of scienter, the determination of whether liability should be imposed in any particular case could be made on the basis of all the relevant factors in each case. An approach along these lines was advocated by SEC Commissioner Sommers in a comment made in regard to the *Lanza* case:

> I would respectively suggest that the considerations which motivated the minority judges in the *Lanza* case will, in the long-run, be better guides as to the responsibility of directors in publicly-held companies than the discussions of scienter, negligence and recklessness contained in the majority opinion. It seems clear to me that in any situation in which the liability of directors under federal securities law is of moment, there should be a very careful effort made to determine which of the directors, because of experience, knowledge, relationship to the corporation and its officers, intimacy of involvement in its affairs, awareness of the consequences of the complaints of corporate acts, should reasonably have been expected to sound the tocsin. I would suggest that this is not an excessive or unduly harsh standard. Just as I think it would be completely unfair to suggest that in every case where a corporation has violated the federal securities laws all of the directors, simply because of their position, have liability, so I would suggest that it is equally unrealistic and unfair to contend that no outside director has any affirmative duties to investigate or monitor or inquire about the conduct of officers of the corporation with respect to compliance with federal securities laws.[103]

In light of *Lanza v. Drexel & Co.*[104] and the subsequent United States Supreme Court decision in *Ernst & Ernst v. Hochfelder*,[105] it appears clear that the "flexible duty standard" advocated by the Ninth Circuit will not be utilized in federal courts in analyzing liability under the securities laws. In

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101. 495 F.2d 724 (9th Cir. 1974).

102. *Id.* at 734.

103. Sommers, *Directors and the Federal Securities Laws*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,669, at 83,806 (1974).

104. 479 F.2d 1277 (2d Cir. 1973).

105. 425 U.S. 158 (1976).

Hochfelder, the Supreme Court adopted the more restrictive view taken by the Second Circuit in *Lanza* and held that negligence was an insufficient basis upon which to predicate liability for violations of rule 10b-5.[106] While *Hochfelder* did not specifically deal with the question of liability under section 20(a), the implication nevertheless appears to be that the scienter requirement is similarly applicable to that section. The majority of cases in which section 20(a) liability has been alleged have been based upon primary violations of section 10(b) and rule 10b-5, and because scienter is required for imposition of primary liability under those provisions, it would seem illogical to impose secondary liability for conduct which is less culpable. Furthermore, recent cases considering the question of liability under section 20(a) appear to follow the analysis utilized in *Lanza*.[107] Thus, consideration of the sufficiency of the good faith defense with respect to section 20(a) liability will apparently continue to be made through a scienter-based approach. However, it remains to be seen whether the duty of the corporate director can be clearly and appropriately delineated through the use of such an approach.

IV. Conclusion

The cases dealing with the liability of corporate directors as "controlling persons" are for the most part inconclusive. While certain guidelines can be derived, no concrete rules are set out upon which liability can be determined. The presence of control is in most instances determined through consideration of all the relevant facts and circumstances of the particular case, with extent of ownership and degree of participation in management and policy-making the most significant factors. This appears to be the preferable means of deciding that issue. Evaluation of the sufficiency of the good faith defense will apparently be based upon a state-of-mind analysis. The most prevalent approach is to require some meaningful sense of culpability by the director before denying his use of the defense. While it is submitted that an approach more closely aligned with the flexible duty standard suggested by the Ninth Circuit could achieve more meaningful results, it remains to be seen whether the defense can be appropriately applied through a scienter-based approach.

Kasey W. Kincaid

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106. *Id.* at 214. *See* note 97 *supra*.

107. *See, e.g.*, Rochez Bros. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); Sun First Nat'l Bank v. Miller, 77 F.R.D. 430 (S.D.N.Y. 1978).