Notes

LIABILITY OF CONTROLLING PERSONS—COMMON LAW AND STATUTORY THEORIES OF SECONDARY LIABILITY

I. Introduction

Since their inception, the Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] have witnessed a continued expansion in both scope and usage. Corporations, their executives and directors, brokers, dealers, shareholders and numerous other professionals have increasingly become the targets of litigation. Yet, despite the growth of securities litigation, the progress of case law in many areas has not been entirely satisfactory. Basic issues have not been decisively resolved, and in the course of complex litigation, individual liability often turns upon the idiosyncracies of a particular court.[3] Rule 10b-5 litigation has witnessed the most rapid expansion[4] in the securities area and has become the center of a large amount of litigation. This has drawn the attention of the courts and commentators from another area of expansion which, although still in the stages of evolution, carries indicia of becoming an area of enormous impact in the corporate world. This is the area of the liability of "controlling persons"[5] under sections 15[6] and 20(a)[7] of the Securities Act of 1933 and the Securities Exchange Act of 1934 respectively.

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1. 15 U.S.C. §§ 77a-aa (1970) [hereinafter Securities Act].
2. 15 U.S.C. §§ 78a-jj (1970) [hereinafter Exchange Act].
3. The Director's Dilemma, Speech of G. Bradford Cook, CCH Fed. Sec. L. Rep. [1973 Transfer Binder] ¶ 79,301 (April 6, 1973).
4. About one-third of all securities law cases, public and private, are brought under rule 10b-5, (17 C.F.R. § 240.10b-5 (1974)), promulgated pursuant to section 10(b) (15 U.S.C. § 78j(b) (1970)) of the Securities Exchange Act of 1934.
5. In this context "control" has apparently been a term which defies precise definition. It appears, however, from the legislative history, that this was an attempt to instill flexibility rather than a lack of intent or ability to define the term.

> 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).

6. 15 U.S.C. § 77o (1970). Section 15 provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* 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.

7. 15 U.S.C. § 78t(a) (1970). Section 20(a) provides:

To clarify the scope of inquiry it must be noted that the liability of "controlling persons" is secondary in nature. A useful classification is one which defines those persons owing direct duties to the public as primarily liable for violations, and those owing duties or incurring liabilities which arise only because another has violated the law as secondarily liable.[8] But even with the recognition by Congress that such secondary liability exists, and the existence of legislation directed specifically at that evil, the courts have not been content to limit their examination for culpable participants but rather have continued to use common law theories of secondary liability for defendants which generally are within the definition of controlling persons under the securities acts.[9] Liability has been imposed on theories of agency,[10] aiding and abetting and conspiracy,[11] misrepresentation and deceit,[12] and finally, although recently, on the basis of rule 10b-5.[13]

It is the purpose of this Note to examine these theories of liability, which exist as alternatives to statutory controlling persons liability. Since the alternate common law liability theories are often advanced and considered together, in the context of statutory liability, it is essential to clarify their scope before considering statutory liability. This analysis will be undertaken with the idea that, although alternative theories should not be discarded or even discouraged, perhaps the most expedient approach to controlling persons liability is through the statutory theories.

II. Alternate Theories of Liability

A. *Agency*

The courts at a very early date applied fiduciary concepts to directors, officers and other insiders in order to hold them accountable to the corporation

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> 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.

8. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. Pa. L. Rev. 597, 600 (1972) [hereinafter cited as Ruder].

9. 15 U.S.C. §§ 77p, 78bb(a) (1970).

10. *See* Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970); John 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).

11. SEC v. Barraco, 438 F.2d 97 (10th Cir. 1971); Carpenter v. Hall, 311 F. Supp. 1099 (S.D. Tex. 1970); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

12. Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

13. Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 359 U.S. 906 (1969); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

in the event of an abuse of responsibility.[14] Although corporations today are readily recognized in all contexts as separate entities, their equity ownership still is lodged in their shareholders. When a director or other fiduciary abuses his position to obtain corporate profits or opportunities, it is a fiduciary violation, not only to the corporation as an entity, but to the shareholders individually as well.[15]

Under familiar common law doctrines a principal is liable for misrepresentations made by his agent if the agent is acting within the scope of his actual or apparent authority.[16] In the area of securities litigation, where agency theory has been utilized, its impact has often been harsh, and actually approaches that of strict liability. For example, in *SEC v. First Securities Co.*,[17] the defendant Nay, president of First Securities and owner of ninety-two percent of its stock, induced each of fifteen claimants to invest, telling them their funds had been deposited in an escrow account. Each of the fifteen claimants had been clients of First Securities, buying and selling in a regular fashion. Each received investment advice from Nay, fourteen of them in his office, and they knew him to be president of First Securities. Substantially all of Nay's correspondence with the claimants was written on the letterhead stationery of First Securities.[18] Nay had no actual authority with regard to the escrow account. Nevertheless, the court in finding liability under agency theory[19] relied upon the concept of apparent authority holding that "a principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud."[20]

Unlike statutory controlling persons liability, under agency theory the only defense readily available is lack of the agency itself.[21] This limitation,

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14. *E.g.*, Attorney General v. Utica Ins. Co., 2 Johns. ch. 371, 389 (N.Y. 1817).

15. Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959), *reh. denied*, 361 U.S. 926 (1960); Blazer v. Black, 196 F.2d 139 (10th Cir. 1952); Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916).

16. RESTATEMENT (SECOND) OF AGENCY § 257 (1958) provides:

> A principal is subject to liability for loss caused to another by the other's reliance upon a tortious representation of a servant or other agent, if the representation is:
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> (a) authorized;
> (b) apparently authorized; or
> (c) within the power of the agent to make for the principal.

17. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

18. SEC v. First Sec. Co., 463 F.2d 981, 984-85 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

19. The court relied upon section 261 and 262 *Restatement (Second) of Agency* (1958). Section 262 provides: "A person who otherwise would be liable to another for the misrepresentations of one apparently acting for him is not relieved from liability by the fact that the servant or other agent acts entirely for his own purposes, unless the other has notice of this."

20. SEC v. First Sec. Co., 463 F.2d 981, 985 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972), *quoting* RESTATEMENT (SECOND) OF AGENCY § 261 (1958).

21. An agency relationship exists only if there has been a manifestation by the principal to the agent that the agent may act on his account, and consent by the agent so to act. RESTATEMENT (SECOND) OF AGENCY § 15 (1958).

inherent in any attempt to use agency theory, will often present insurmountable obstacles in the attempt to impose liability upon secondary defendants.[22] In *Sennott v. Rodman & Renshaw*,[23] unlike the liberal construction of liability under agency theory, the court construed both the availability and the applicability of this defense narrowly. In *Sennott*, a commodities trader brought suit against the defendant brokerage house alleging a fraudulent sale of securities. The son of a partner, though not employed by the firm, did use the firm telephone on the trading floor. This appeared to create an apparent agency relationship and only the defendant's clear showing that the plaintiff had flatly refused to cooperate in the investigation by the firm into the son's activities, and that the purchase was consumated by a secret agreement between the plaintiff and the son was sufficient to disprove agency.[24]

It is logical that the usage and definition of agency theory must necessarily be more narrow than that of the control relationship. In section 15 of the 1933 Securities Act, agency, while included and presumably encompassing the same application as common law agency, is only one of several exemplary means of control liability. There is nothing peculiar in the relationship between the broker and his representative which should, however, preclude application of common law agency principles.[25] In any event, as seen in *John Hopkins University v. Hutton*,[26] agency theory may be available as an alternate theory of liability under proper circumstances. John Hopkins brought suit against W. E. Hutton & Co. to rescind a purchase, alleging a false representation by a Hutton employee. The district court held that the controlling persons' liability under section 15 supplements common law principles of agency.[27]

> The legislative history and case law, to the extent there is any, would appear to buttress a construction of Section 15 to exclude application of the latter to an employment relationship. A contrary conclusion would in effect give blessing to a hear-no-evil, see-no-evil approach by partners of a brokerage house which is hardly in keeping with the remedial purposes of the '33 Act . . . .[28]

The Fourth Circuit agreed with the district court's application of the agency principles.[29] Thus it appears that agency theory will continue to be

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22. *See* Ruder, *supra* note 8, at 605.
23. 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973).
24. Sennott v. Rodman & Renshaw, 474 F.2d 32, 39 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973).
25. Fey v. Walston & Co., 493 F.2d 1036, 1052 (7th Cir. 1974).
26. 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part and rev'd in part*, 422 F.2d 1124 (4th Cir. 1970).
27. John Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1212 (D. Md. 1968), *aff'd on this point*, 422 F.2d 1124 (4th Cir. 1970).
28. *Id.* The real concern of the *Hutton* court was that the defendants would escape liability under section 15 of the Securities Act of 1933 due to the application of its statutory defense provisions. Consequently, the court justified the application of agency principles, and once agency was found to exist, was able to impose liability without concern for the statutory defenses.
29. 422 F.2d 1124, 1128, 1131 (4th Cir. 1970).

applied to securities law cases, and where so applied, will often create liability subject only to the defense that no agency in fact existed.[30]

B. *Aiding and Abetting and Conspiracy*

It is clear that one who aids and abets a violation of section 10(b)[31] of the Securities Exchange Act of 1934 and rule 10b-5[32] may be civilly liable to one who is injured thereby.[33] Moreover, liability may be predicated on aiding and abetting where there is found to be less than actual knowledge and participation in the activity proscribed by section 10(b) and rule 10b-5.[34] In *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[35] plaintiff was the trustee in bankruptcy for Dobich Securities Corporation which had engaged in the sale of securities as a dealer. The defendant allegedly knew that Dobich was using fraudulently converted property in his securities transactions. The court said:

> It is well settled that parties may be liable for violations of the Act and Rule 10b-5 as long as they engage in fraudulent activity "in connection with" the sale or purchase of securities or in a fraudulent "course of business". . . . We are persuaded that Count II sufficiently alleges that defendant benefited by a course of business which operated as a fraud upon the bankrupt's customers. . . .[36]

In *SEC v. First Securities Co.*,[37] the court discussed both the *Buttrey*[38] and *Brennan*[39] decisions as a preface to a discussion of liability under the aiding and abetting theory. The court noted that *Buttrey* had held a broker-dealer liable as an aider and abettor of a rule 10b-5 violation arising from acts committed by a customer of the brokerage firm. The act of the brokerage firm which had provided a foundation for the secondary liability was allowing the customer to trade in securities through a cash account in spite of his known financial instability and "erratic trading practices."[40] The court also noted that in the

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30. Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970). *See also*, Ruder, *supra* note 8, at 608; Note, *The "Controlling Persons" Liability of Broker-Dealers For Their Employees' Federal Securities Violations*, 1974 DUKE L.J. 824 (1974).

31. 15 U.S.C. § 78j(b) (1970).

32. 17 C.F.R. § 240.10b-5 (1974).

33. Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969); Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949).

34. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

35. 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

36. 410 F.2d at 144.

37. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

38. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

39. Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

40. SEC v. First Sec. Co., 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

Brennan case an insurer of stock was held liable as an aider and abettor to similar violations committed by a dealer in the stock on the ground that the president and general counsel of the insurer knew or should have known that the dealer was defrauding the purchasers of the issuer's stock.[41] The court then concluded that the instant case presented a far more compelling reason for the imposition of liability as an aider and abettor than either *Buttrey* or *Brennan*. First Securities made Nay its president, provided him with the appearance of a successful investment counselor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of frauds of the type which had occurred.[42]

Sufficient case law exists to indicate that aiding and abetting and conspiracy will continue to be utilized in securities litigation.[43] However, it is doubted whether they will be utilized to any great extent. To establish liability for aiding and abetting, first an independent violation of the securities laws must be shown.[44] Without such an independent violation, there cannot possibly be a secondary violation. The substance of the secondary violation in this instance is an aiding and abetting, or conspiracy in, the commission of a primary violation. Secondly, by definition, there must be shown some form of knowledge or scienter. Regardless of whether scienter is a necessary element of the primary violation, it must necessarily be shown in the secondary violation to establish liability.[45] It is this requirement of scienter which must relegate aiding and abetting and conspiracy doctrines subservient to other theories of secondary liability.

C. *Rule 10b-5*

Although technically rule 10b-5[46] violations should be classified as theories of primary liability, there is a line of case law holding controlling persons secondarily liable for 10b-5 violations.[47] This is in the area which is

41. 463 F.2d at 988.

42. *Id.* The rule regarding the opening of mail which First Securities allowed and enforced was one of Nay's own instigation. The rule was that mail addressed to the firm at its office marked for the president's attention was to be opened by no one but him. Obviously Nay had requested this procedure to shield any possible discovery of his fraudulent activity. Regardless of the fact that he was successful, First Securities was still liable as an aider and abettor. Apparently the court felt that this procedure was so indicative of fraudulent behavior that First Securities was for all practical purposes in violation of the securities laws by even allowing this procedure to continue.

43. SEC v. Barraco, 438 F.2d 97 (10th Cir. 1971); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified and aff'd*, 430 F.2d 1202 (9th Cir. 1970); Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966).

44. Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

45. *See* Ruder, *supra* note 8, at 620-38 and discussion therein.

46. 17 C.F.R. § 240.10b-5 *promulgated pursuant to* 15 U.S.C. § 78j(b) (1970).

47. *E.g.*, Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

customarily labeled as "internal corporate mismanagement" by the rule 10b-5 literature.[48] Primarily this is the area where inside directors, officers or dominant corporate shareholders involve the corporation in fraudulent securities transactions to the detriment of the corporation and for the benefit of the instigating participants. Among such practices are the issuance of stock to themselves for an inadequate price, either for monetary gain or for the accumulation of power,[49] contriving a merger with the primary benefit going to the controlling persons to the detriment of the corporation itself[50] and consolidation of their control by redemption of outstanding securities of the corporation.[51]

The leading case in this area is *Schoenbaum v. Firstbrook.*[52] In *Schoenbaum*, minority shareholders brought suit against the majority shareholder alleging he had used his control to acquire shares at a vastly inadequate price. In its opinion, the Second Circuit announced a two-step test for determining whether secondary defendants were liable for violations of rule 10b-5: first, whether defendants had utilized a controlling influence to induce the transactions in question, and second, whether the transaction was unfair to the corporation.[53] It is readily apparent that the Second Circuit, in utilizing its two-pronged approach to ascertain corporate mismanagement, is creating a problem for itself analogous to the problem currently existing under the controlling persons sections of the Securities Act of 1933 and the Securities Exchange Act of 1934. The first step in the test requires ascertaining whether defendants utilized a controlling influence. As has been the case elsewhere, no precise definition of controlling influence can be formulated.[54] The line of cases utilizing rule 10b-5 is both divergent and confusing. The Second Circuit itself has vascillated in its approach.[55] It is submitted that with the vagrancies in the approach to corporate mismanagement cases, and keeping in mind that they are an attempt to impose primary liability upon secondary defendants, this approach should at best play a minor role in extending liability to controlling persons.[56]

48. 6 L. Loss, Securities Regulation 3631 (Supp. to 2d ed. 1969).

49. Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964).

50. Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967); Eagle v. Hovarth, 241 F. Supp. 341 (S.D.N.Y. 1965).

51. Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1971), *rev'd on other grounds*, 453 F.2d 736 (2d Cir. 1972) (en banc).

52. 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

53. Schoenbaum v. Firstbrook, 405 F.2d 215, 219-20 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

54. Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970).

55. *Compare* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969) *with* Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964). *See* Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 Harv. L. Rev. 1007 (1973).

56. For a discussion of developmental case law and an argument for utilization of the *Schoenbaum* two-pronged test in corporate mismanagement cases see Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 Harv. L. Rev. 1007 (1973). An argument can of course be made that rule 10b-5 liability is not designed to reach the same type of securities violations as the controlling persons sections. Theo-

III. Controlling Persons Liability Under the Securities Act and the Exchange Act

A. *Legislative History*

Section 15 of the 1933 Securities Act originally provided:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.[57]

However, in response to criticism that it was "too drastic" and that it was "interfering with business"[58] the Securities Act was amended. A special defense was included by which a controlling person is not liable if he had "no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[59] Section 15 in the original Senate version was designed to prevent the evasion of liability under the securities laws through the exercise of power through a "dummy" director[60] with the intent to defraud.[61] The "dummy" terminology, while not incorporated in the final version of the Act, does give some indication toward the type of liability Congress thought it was reaching through section 15 of the 1933 Securities Act. It was with the intention of limiting the application of section 15 to those situations where a controlling person had effectively exercised his control to bring about the violation that Congress amended section 15 in 1934.[62]

At the time Congress was amending the Securities Act of 1933 it also enacted the Securities Exchange Act of 1934.[63] The Exchange Act also contained

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retically, corporate mismanagement liability would be imposed on those control persons who are primarily liable in the first instance, rather than vicariously liable for the acts of others. However, the main thrust of corporate mismanagement liability has been towards elimination of deception, reliance, and scienter requirements in rule 10b-5 actions. This would not only make control persons liable for their own acts, but also for the acts of others without the benefit of statutory or common law defenses. The result would be an expansion of secondary liability beyond that which was originally seen in the controlling persons statutes.

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

58. 78 Cong. Rec. 8668 (1934) (remarks of Senator Fletcher).

59. 15 U.S.C. § 77o (1970). The purpose of this amendment was to "restrict the scope of the section so as more accurately to carry out its real purpose. The existence of control is not made a basis for liability unless that control was effectively exercised to bring about the action upon which liability is based." 78 Cong. Rec. 8669 (1934) (memorandum submitted by Senator Fletcher).

60. S. 875, 73d Cong., 1st Sess. §§ 2(k), 4, 13 (1933). The Senate draft defined "dummy" as a person with nominal authority or power to act but who was under an obligation to act under the direction of another. S. 875, 73d Cong., 1st Sess. § 2(k) (1933).

61. S. 875, 73d Cong., 1st Sess. § 13 (1933). This section provided in part: "It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly . . . wilfully to employ any device, scheme, or artifice or to employ any 'dummy' or to act as any such 'dummy' with the intent to defraud . . . ."

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

63. 15 U.S.C. § 78 (1970).

a controlling persons provision similar to that of the Securities Act.[64] It was in the context of the 1934 Exchange Act and the 1934 amendment to the 1933 Securities Act that the terms "control", "controlling person" and "controlled person" were first introduced.[65] Nothing appears in the Acts or in the legislative history to further clarify precisely what Congress meant by "control". Congress, apparently by design, has left the boundaries of definition to be decided on the basis of the factual context of each situation on a case by case basis. It is clear from case law that a variety of defendants may be found to be control persons. Liability has been extended to a firm for the acts of the owner's son (a former employee),[66] to corporations for the acts of their directors,[67] to directors for the acts of other officers,[68] to promoters for the acts of other promoters,[69] to brokerage firms for the acts of their correspondents,[70] to brokerage firms for the acts of their employees[71] and to minority shareholders for the acts of officers and directors.[72] However, the real issue in securities litigation under the controlling persons provisions of the Securities Act and the Exchange Act is not who has been held liable, but rather upon what standards their liability has been determined.

B. *What is Control*

As noted, Congress intended a very broad definition of control.[73] The best statement of this policy has been reflected in *Myzel v. Fields*.[74] There the

64. 15 U.S.C. § 78t(a) (1970). *See* note 7 *supra*. The defense available to controlling persons under the Exchange Act is: "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

65. Control is not defined, and this was deliberate according to the House Report which states:

> In this section and section 11, when reference is made to "control", the term is intended to include actual control as well as what has been called legally enforceable control. (See Handy & Harmon v. Burnet (1931) 284 US. 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. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

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

66. Sennott v. Rodman & Renshaw, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973).

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

68. 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 also*, Mader v. Armel, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027 (S.D. Ohio 1971), *aff'd*, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).

69. Strong v. France, 474 F.2d 747 (9th Cir. 1973).

70. Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949). A correspondent is a dealer in stocks who, because not a member of the exchange, must have his orders executed through a broker.

71. Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

72. Jezarian v. Csapo, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,795 (S.D.N.Y. 1973).

73. *See* note 65 *supra*.

74. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

court said: "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."[75] In cases following the line of reasoning of the *Myzel* court, sections 15 and 20 of the Securities Act and the Exchange Act, respectively, have been viewed as an extension of the general common law doctrine of respondeat superior.[76] Generally managers, officers and directors, and majority stockholders are found to be persons controlling a corporation or other entity, and thus liable for its frauds. Conversely, frequently the direction of the transmittal of responsibility has been reversed by holding that a corporation or other entity is a controlling person and subject to liability for the conduct of an agent, representative or correspondent even though the law of agency itself might or might not sustain such liability.[77]

Two discernible lines of authority can be identified in the attempt to define what type or quantum of control will be necessary to establish a person or entity as a controlling person in securities litigation. The first line of demarcation in cases explicitly construing a definition of control views the term as a static concept requiring no affirmative conduct upon the part of the controlling person to impose liability.[78] In *Moerman v. Zipco, Inc.*,[79] plaintiff, a purchaser of securities, alleged that the president of Zipco had represented to him that the issue of securities would be small. In fact there were 227 subscribers to the 175,000 share issue. Plaintiff demanded a return of the consideration paid. The court held:

> Based on their actions at the board meetings and their sale of stock, 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 of actual direction."[80]

Zipco was held liable for the fraud of its president. The control of Zipco included the indirect control of its president. Thus, all of the directors, by their control of Zipco were said to be in control of, and responsible for, the

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

76. Mader v. Armel, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972); Kemmerer v. Weaver, 445 F.2d 76 (7th Cir. 1971); Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955).

77. Fey v. Walston, 493 F.2d 1036, 1052 n.16 (7th Cir. 1974); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971); Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970); Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966).

78. Harriman v. E.I. duPont Nemours & Co., 372 F. Supp. 101 (D. Del. 1974); Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890, 915 (D. Me. 1971); 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). This has been termed the control by status approach. 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, 1021-22 (1973).

79. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

80. 302 F. Supp. at 448. Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

acts of Zipco's president unless they sustained their burden of proving that they acted in good faith.[81]

Another line of cases requires a showing of control in fact over the activities constituting the alleged violation.[82] To impose liability upon directors simply because of their status as directors would, even in light of the statutory defenses provided, be a major step towards the imposition of strict liability theory in securities law.

The legislative history of the securities laws with its reference to "legally enforceable control"[83] arguably could support the proposition that this section was intended to embrace those who merely by their position may be deemed to be in control. However, as was said in *Lorenz v. Watson*,[84] "[e]ach provision of the Act must be interpreted in light of the evil Congress sought to prevent."[85] The burden of liability is imposed upon controlling persons to deter conduct which is violative of the securities laws. If a person is not in control or in a position to influence conduct, although he may be an officer or director, the sanction of liability is not, as to him, apt to change his actions. On the other hand, in cases such as *Lorenz* where failure to supervise was considered a violation, it would appear that even a non-controlling director could supervise conduct and perhaps prevent a securities violation from taking place.

To define control in terms of quantum of ownership or degree of control would be to place precise limitations upon the bounds of the controlling persons sections and would be at odds with the remedial purposes of the acts. Rather, courts should develop control status based on the facts of each case, considering all relevant factors which indicate an exercise of restraint, direction or command. In *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*,[86] factors which were considered to demonstrate control of a correspondent broker were that:

> The defendants directed Waddy in the conduct of his business by furnishing him the wire, the cotton ticker, prescribing the form of accounts, prescribing the manner in which accounts . . . were to be handled, furnished part of the forms for the transaction of his business, checked and approved his confirmation forms . . . and particularly directed him in his compliance with the rules of the exchange.[87]

In *Richardson v. MacArthur*,[88] in discussing control of the agent MacArthur by Bonneville, a Utah insurance corporation, the court said:

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81. *Id.*
82. Klapmeier v. Telecheck Int'l, Inc., 482 F.2d 247 (8th Cir. 1973); Sennott v. Rodman & Renshaw, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957); Mader v. Armel, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027 (S.D. Ohio 1971), *aff'd*, 401 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).
83. *See* note 65 *supra*.
84. 258 F. Supp. 724 (E.D. Pa. 1966).
85. 258 F. Supp. at 733.
86. 85 F. Supp. 104 (W.D. Ark. 1949).
87. 85 F. Supp. at 123.
88. 451 F.2d 35 (10th Cir. 1971).

> MacArthur was the man selected by Bonneville to develop Bonneville in California. In this capacity and with the knowledge and consent of Bonneville's officers, MacArthur not only set up Bonneville's agency in California and obtained certification for Bonneville to sell insurance there, but he also prospected California for mergers and acquisitions. In sum, he dealt with practically any matter affecting Bonneville in California. Since MacArthur regularly reported to Bonneville's executive committee concerning those vast dealings which he was undertaking for Bonneville in California, it cannot now be claimed that Bonneville lacked influence to control, direct or discipline MacArthur with regard to those dealings.[89]

It will be noted that in neither *Hawkins* nor *Richardson* did the defendant controlling person actually control the specific fraudulent activity of the employee, agent or correspondent. Nevertheless, they were found to be controlling persons within the meaning of the Acts. This is because they were, in fact, in control of the general activities of their employees. Their control was an all encompassing sphere. When the agent or employee steps beyond this sphere of control, it does not eliminate the status of the defendant as a controlling person, but rather brings him within another adjacent sphere of statutory defense to controlling persons liability. It is submitted that this is exactly the analysis both intended by Congress and needed by the courts if the controlling persons sections are to become an effective means of reaching the goals of the securities acts. It will also be noted that this is an approach which lies somewhere between the two predominant lines of authority considering a definition of controlling persons, those of control by status and control in fact.

This view can be demonstrated by *Klapmeier v. Telecheck International, Inc.*,[90] where it was said:

> The issue of "control" is a complex fact question which requires an examination of the relationships of the various alleged "controlling persons" to the person or entity which transacted the sale of securities alleged to have violated the Act, an examination which cannot be limited to a cursory review of their proportionate equity positions, employment or director status on relevant dates. While a majority shareholder might as a matter of law be held to "control" the entity regardless of his actual participation in management decisions and the specific transaction in question, the absence of a substantial ownership of shares does not foreclose liability under the Act as a "controlling person."[91]

The issue of whether a particular defendant is constructively a controlling person should be faced only in the event the evidence fails to establish that quantum of actual control contemplated by the securities acts.[92] It has been

89. 451 F.2d at 42 (footnote omitted).
90. 315 F. Supp. 1360 (D. Minn. 1970), *rev'd and remanded on other grounds,* 482 F.2d 247 (8th Cir. 1973).
91. Klapmeier v. Telecheck Int'l, Inc., 315 F. Supp. 1360, 1361 (D. Minn. 1970), *rev'd and remanded on other grounds,* 482 F.2d 247 (8th Cir. 1973).
92. *Id.*

said that the purpose of the controlling persons sections is to impose liability only upon those who fall within its definitions and are in some meaningful sense culpable participants.[93] This is a valid conclusion, yet quite logically it can be reached through the same analysis used in the *Hawkins*, *Richardson* and *Telecheck* decisions. Under proper analysis, there is no need to restrict the scope of what can be termed culpable control, for where fairness requires restriction it can be found within the statutory defenses.

In *White v. Abrams*,[94] although primarily within the context of a rule 10b-5 action the court developed an interesting approach in this regard.

> 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. By adopting such a duty analysis, we avoid the confusion that arises from classifying the defendants as primary and secondary, or from classifying the transactions as direct or indirect.[95]

The approach taken in *White* may well be a workable solution to the problem of defining control and ascertaining the controlling person. It would involve a factual determination and an imposition of liability based upon the merits of that factual determination rather than a strict departmentalization of defendants and degrees of liability.

IV. Exclusivity

Since the common law theories of liability which were discussed earlier existed long before the imposition of secondary liability under the securities acts, and since they often contain less readily available defenses than the securities acts, secondary defendants have argued that the securities acts should be, and were intended to be, the exclusive theory of liability. They reach this conclusion by pointing to the statutory defenses afforded to all controlling persons under the securities acts, and arguing that unless statutory liability is exclusive it will merely be superfluous in most cases of secondary liability.[96] Two cases have specifically upheld the doctrine of exclusivity.[97] In *SEC v. Lum's, Inc.*,[98] liability was predicated on an agency or respondeat superior doctrine. The defense contended that the existence of statutory liability implied a congressional intent that other theories of secondary liability were inapplicable. They argued that employer-employee, principal-agent and broker-dealer relationships were within the controlling persons sections.[99] Although it is uncertain whether

93. Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).
94. 495 F.2d 724 (9th Cir. 1974).
95. 495 F.2d at 734.
96. *See* Note, *Brokerage Firm's Liability for Salesmen's Fraudulent Practices*, 36 Fordham L. Rev. 95, 101 (1967).
97. Gordon v. Burr, 366 F. Supp. 156 (S.D.N.Y. 1973); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973).
98. 365 F. Supp. 1046 (S.D.N.Y. 1973).
99. Defendant Lehman Brothers' Post-Trial Memorandum of Law at 52, SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973)

the court actually considered the controlling persons sections as exclusive, it did reject the SEC contention, holding that section 20(a) was applicable and rejecting liability on a good faith defense.[100] Nevertheless, in *Gordon v. Burr*,[101] the court held that where section 20(a) was applicable there was no basis for applying the theory of respondeat superior, given the existence of an express statutory remedy.[102]

On the other hand, in *John Hopkins University v. Hutton*,[103] it was expressly held that the partners of a broker-dealer were liable for the frauds of their employee committed in the course of his employment, and that the "controlling persons" standard of liability did not apply to the employer-employee relationship.[104] "What legislative history there is does not indicate that Congress intended Section 15, originally or as amended, to serve as a limitation on liability."[105] The district court, joined by the Fourth Circuit, felt that section 15 should be seen only as establishing a "controlling persons" liability which would suppplement and extend beyond common law. Other courts, while not specifically addressing the issue have applied agency principles instead of the relevant controlling persons sections of the acts, thus stripping defendants of their statutory defenses.[106] In light of the limitations inherent in common law theories discussed above, and in light of courts propensities to search for alternate theories of liability[107] it would seem that few courts will construe statutory liability as exclusive. This, it is submitted, accords with both the remedial purposes of the act and the language itself which, at least in section 15, speaks to control "through agency or otherwise." It seems likely that the specific statutory sanctions will be available only in those instances where liability can be imposed only under the statutory theory.[108]

V. Statutory Defenses

A. *The 1933 Act: Section 15*

As noted above[109] the 1933 Act was amended to include as a statutory

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100. SEC v. Lum's, Inc., 365 F. Supp. 1046, 1064-65 (S.D.N.Y. 1973).
101. 366 F. Supp. 156 (S.D.N.Y. 1973).
102. 366 F. Supp. at 168.
103. 422 F.2d 1124 (4th Cir. 1970).
104. 422 F.2d at 1130.
105. John Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1211-12 (D. Md. 1968), *aff'd on this point*, 422 F.2d 1124, 1130 (4th Cir. 1970). The court further said:

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

297 F. Supp. at 1212.

106. Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); John Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970), *aff'g in part and rev'g in part* 297 F. Supp. 1165 (D. Md. 1968); Armstrong, Jones & Co., 421 F.2d 359 (6th Cir. 1970).
107. SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).
108. *See* Ruder, *supra* note 8, at 608.
109. *See supra* notes 57-62 and accompanying text.

defense a section which provides that a controlling person will not be liable if he had "no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[110] This amounts essentially to a defense which must be scrutinized on a factual basis. Actual knowledge may, of course, be ascertained by objective standards and, "reason to believe", while measuring liability by hindsight, may also be established with reasonable objectivity.

It is submitted that the defense standard under section 15 of the Securities Act of 1933 is more difficult to satisfy than the analogous defense under section 20(a) of the 1934 Securities Exchange Act. If, as was noted in *John Hopkins University v. Hutton*,[111] a hear-no-evil, see-no-evil attitude by secondary defendants was sufficient to establish a defense under section 15, then the act would hardly seem to accomplish its remedial purpose. Quite the contrary, it would seem such a construction would actually foster securities violations, as the primary defendant would operate in a context screened from supervision. However, it appears, as was noted in *DeMarco v. Edens*,[112] as long as defendants exercised reasonable care in the selection and supervision of the primary participant in the securities law violations, they would be seen as establishing their statutory defense. Conversely, however, it appears that if the defendants fail to exercise reasonable care they would not be able to avail themselves of the statutory defense. The failure to meet a standard of reasonable care seems to be that of mere negligence.[113] Consequently, courts, when considering whether defendants meet this statutory standard as a defense will need to find only some failure to exercise reasonable care to deprive a secondary defendant of any statutory defense under section 15 liability.

It is somewhat contradictory in a sense, that under section 15 of the Securities Act only a minor implied burden of investigation appears[114] and yet mere negligence will suffice for liability, while under section 20(a) of the Exchange Act defendants are often required to exercise a high degree of supervision or affirmative action to establish their good faith defense. Under section 20(a) a higher degree of culpability is required. Yet that is the only logical interpretation which may be given to case law under section 15. It might be added that it is logical in another sense that where a higher burden of affirmative action is required, more culpable conduct will be required to establish liability while with lesser supervision required negligence will suffice.

110. 15 U.S.C. § 77o (1970).

111. 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part and rev'd in part*, 422 F.2d 1124 (4th Cir. 1970).

112. 390 F.2d 836 (2d Cir. 1968).

113. *See* Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 123 (W.D. Ark. 1949).

114. DeMarco v. Edens, 390 F.2d 836, 842-43 (2d Cir. 1968); Hawkins v. Merrill Lynch Pierce, Fenner & Beane, 85 F. Supp. 104, 123 (W.D. Ark. 1949); Folk, *Civil Liabilities Under the Federal Securities Acts: The Barchris Case, Part II—The Broader Implications*, 55 VA. L. REV. 199, 216-24 (1969) (suggesting that the statutory defense imposes a duty similar to that imposed under section 12(2) of the 1933 Act).

But it is hard to find justification for this analysis in the language of the acts themselves.

B. *The 1934 Act: Section 20(a)*

It has been suggested that:

> [T]he 1934 Act gives the controlling person a seemingly readier defense than the 1933 Act. Under section 20(a) of the 1934 Act the controlling person need prove only that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the cause of action," whereas under Section 15 of the 1933 Act the controlling person must prove that he "had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist."[115]

The most commonly cited case construing section 20(a) defenses is *Lorenz v. Watson*.[116] Under allegations of "churning"[117] an account, the court, with respect to the good faith defense, said that to satisfy the act "it is necessary for the [controlling person] to show that some precautionary measures were taken to prevent the injury suffered."[118] Failure of a controlling person to properly maintain and diligently enforce a proper system of internal supervision and control has been held to constitute participation in the misconduct and will be deemed to have been committed by the controlling person.[119] Liability is clearly distinguishable under section 20(a) from that of section 15 with the recognition that where the evidence shows that the controlling person is the actual intended beneficiary no knowledge of the wrongdoing is required. The situation is directly analogous to the generally understood concept that a principal need not have knowledge of the frauds of his agent before liability may be imposed.[120] It appears, however, that the burden of proving good faith or non-inducement is much easier than that of proving freedom from negligent conduct.[121] In *SEC v. Lum's, Inc.*,[122] the court was unwilling to impose liability upon a secondary defendant because an actual internal supervision system had been utilized, although obviously not effectively.[123] It appears that the secondary defendant must be found to be "in some meaningful sense culpable . . ."[124] such as was the case in *SEC v. First Securities Co.*,[125] where the firm actively enforced a policy which led to a securities

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115. 3 L. Loss, Securities Regulation 1747 (2d ed. 1961) (citation omitted).
116. 258 F. Supp. 724 (E.D. Pa. 1966).
117. Churning involves overactive trading of an account to generate commissions.
118. Lorenz v. Watson, 258 F. Supp. 724, 732 (E.D. Pa. 1966).
119. SEC v. First Sec. Co., 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).
120. Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).
121. *See* notes 10 and 11 *supra* and accompanying text.
122. 365 F. Supp. 1046 (S.D.N.Y. 1973).
123. 365 F. Supp. at 1065-66.
124. Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).
125. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

law violation.[126]

Statutory defense under section 20(a) requires good faith and non-inducement. Since the legislative history indicates that liability cannot be predicated on control unless it is *effectively* exercised,[127] the conclusion which obviously must be reached is that mere negligence will not sustain liability under section 20(a). This is exactly the result which was reached in *Hughes v. Dempsey-Tegeler & Co.*,[128] when the court was directly confronted with the issue. The court said that: "a controlling person cannot be held accountable for that which he did not intend, nurture, encourage, condone, sanction or otherwise induce."[129] In *Lanza v. Drexel & Co.*,[130] the court held that "a director . . . owes no duty to insure that all material, adverse information is conveyed to prospective purchasers . . . ."[131] Thus it appears that under section 20(a) affirmative action is required. However, more than mere negligence is required to replace whatever affirmative action has been taken by the secondary defendant. There still exists, however, a certain amount of confusion as to how much affirmative action is required as can be seen by a comparison of the *Lanza* and *Lorenz* decisions. In the final analysis it would appear that the approach in *Lorenz* could be effectively utilized in situations such as that presented in *Lanza*. A duty to supervise could be imposed, and liability assessed for non-supervision, without any undue burden. It could take into account many factors such as knowledge of the specific fraudulent activity,[132] the degree of benefit obtained by the secondary defendant,[133] and whether the secondary defendant knew of the existing potential for fraud.[134] Such a duty is neither unfair nor inconsistant with a reading of the act itself.

VI. Conclusion

In the increasing amount of securities litigation under the guise of secondary liability, courts often are confronted with numerous alternative theories of liability, and are often prone to establish or deny liability under more than one.[135] Consequently, the burden of defending such litigation is often immense.[136] While recognizing that many common law secondary liability theories do present a useful, if somewhat limited function, it is submitted that

126. *See* note 42 *supra* and accompanying text.
127. *See* note 59 *supra*.
128. [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,133, at 94,551 (C.D. Cal. Sept. 4, 1973).
129. *Id.*
130. 479 F.2d 1277 (2d Cir. 1973).
131. 479 F.2d at 1289.
132. 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).
133. Mader v. Armel, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,027 at 90,799 (S.D. Ohio 1971), *aff'd*, 461 F.2d 1123 (6th Cir.), *cert. denied*, 409 U.S. 1023 (1972).
134. Richardson v. MacArthur, 451 F.2d 35, 41-42 (10th Cir. 1971).
135. SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).
136. *See, e.g.*, Carpenter v. Hall, 311 F. Supp. 1099 (S.D. Tex. 1970) (93 defendants were named, primarily on theories of secondary liability).

sections 15 and 20(a) of the Securities Act of 1933 and the Securities Exchange Act of 1934 respectively should be utilized more often. Following a factual analysis such as is suggested in the *Telecheck*[137] decision, courts can expand their definition of control without expanding liability as is suggested in several cases above.[138] The enormous potential for abuse which exists in the securities area demands that control include within its bounds all of the activities of those persons acting under the direction, supervision or authority of another. Yet if the statutory defenses are considered with an eye towards fairness in dealing with the individual defendants, the burden of liability need not be too great. If control is determined upon an actual rather than a status basis, the secondary defendant who is determined to be a control person can escape liability by sustaining his statutory defense by showing that the activity was within the sphere of control where the statutory defense is applicable.

It is imperative that a more cohesive body of law develop around the sections which, in today's world of directors and conglomerates, impose liability on those who operate behind the scenes of the business structure. If the courts reject the exclusivity doctine, and keep one eye towards the common law doctrines as supplemental theories, controlling persons' liability can perhaps develop into a consistant body of law which will further the original goals of the securities laws.

RANDALL G. HORSTMANN

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137. Klapmeier v. Telecheck Int'l, Inc., 482 F.2d 247 (8th Cir. 1973).
138. *See* notes 86-90 *supra* and accompanying text.