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"The common law is not a brooding omnipresence in the sky but the articulate voice of some sovereign or quasi-sovereign that can be identified; although some decisions with which I have disagreed seem to me to have forgotten the fact."

INTRODUCTION

Section 20(a) of the Securities Exchange Act of 1934 (1934 Act) imposes liability on any person who controls another person who commits a violation of any section of the Act. The section is modeled on the provision of the Securities Act of 1933 (1933 Act) that imposes liability upon persons controlling those who violate the 1933 Act. These sections have been used to determine the liability of brokerage firms for securities law violations committed by their registered repre-
sentatives. While this situation has been the principal source of litigation, these sections have also been used to determine the liability of other types of employers and principals who exercise control over those who violate the sections.

In recent years, a number of federal courts have taken the position that secondary liability for the securities law violations of employees may also be imposed on employers through the application of generalized common-law principles of agency and respondeat superior.

Other courts have maintained that the controlling persons sections of the acts are the exclusive means of imposing secondary liability on


7. Four circuits follow this rule. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 699 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Holloway v. Howerdd, 536 F.2d 690, 694 (6th Cir. 1976); Fey v. Walston & Co., 493 F.2d 1036, 1032 (7th Cir. 1974). The Third Circuit, which long held that the statutory provisions are exclusive, appears to have reversed its leading case, Rochez Bros. v. Rhoades, 527 F.2d 880, 884-86 (3d Cir. 1975), or at least drastically limited it by creating a special duty exception. Sharp v. Coopers & Lybrand, 649 F.2d 175, 184-85 (3d Cir. 1981). The First Circuit has not addressed this issue, but one district court in that circuit has stated that both theories of liability are appropriate. Kravitz v. Pressman, Frohlich &
employers under the securities acts. This difference in statutory construction is of great significance because section 20(a) of the 1934 Act grants a defense to controlling persons who demonstrate that they have acted in "good faith." Section 15 of the 1933 Act contains a similar provision. There is, however, no such defense available in an action based on common-law principles of agency and respondeat superior, under which the inquiry is, respectively, into the scope of

Frost, Inc., 447 F. Supp. 203, 214 (D. Mass. 1978). It is clear that the common law being applied is federal, not state, law. See infra note 82.


10. 15 U.S.C. § 77o (1976); see supra note 3. While § 20(a) phrases the defense as one of good faith, the § 15 defense is premised on a defendant's lack of "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). Professor Loss is of the opinion that the § 15 defense provides controlling persons with a "seemingly readier defense" than § 20(a). 3 L. Loss, Securities Regulation 1747 (2d ed. 1961).

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the agent's authority12 or the servant's employment.13 As a result, an employer who might have escaped liability in an action based solely on the securities statutes may be found liable through application of common-law principles.14

This Note argues that the legislative history of the 1933 Act and the 1934 Act indicates that the sections were intended to include employment relationships. This Note then concludes that because employment relationships are covered by the statute, the judicial application of generalized common-law principles to actions under the securities statutes is an unjustified creation of federal common law.

I. THE SCOPE OF THE CONTROLLING PERSONS SECTIONS

The securities acts are broad and comprehensive federal legislation representing the intent of Congress to regulate the securities industry.16 The Acts are specific in their provisions for methods of imposing secondary liability on those who control violators of the Acts.17 Secondary liability is thus typically imposed upon majority shareholders for actions of their "dummy" directors,18 employers for conduct of their employees,19 such as in the brokerage-firm context,20

17. See supra notes 1-4 and accompanying text.
and generally upon whomever can be said to control others, such as close family members.21

A. Statutory Construction

The development of the line of cases that permits actions based on both common-law principles and the securities acts22 found its genesis in the assertion that the controlling persons provisions do not cover the "ordinary employer-employee context."23 Rather, it was argued, they were "designed to reach situations in which there are technical legal barriers between the persons in fact responsible for violations of the securities acts and those injured by the violations."24 Under this view, the liability of employers, therefore, should be determined "under the antifraud provisions themselves."25 Because under the statutory scheme the antifraud provisions cannot be applied to impose secondary liability without resort to the controlling persons provi-
sions, this rationale constitutes an improper application of the antifraud provisions by means of common-law agency principles.

The first decision to so employ agency principles was *Johns Hopkins University v. Hutton.* The court in *Johns Hopkins* cited several legislative materials for its disbelief that "[s]ection 15 . . .

Secondary liability based upon a questionable symbiosis of statutory and common law, see id. at 1530-31, is a needless complication and derives from a misinterpretation of congressional intent. See infra pt. I(B).

26. Legal entities other than natural persons are included in the definitions of "person" in both Acts. 15 U.S.C. § 77b(2) (1976); Id. § 78c(a)(9); SEC Brief, supra note 15, at 12-13 & n.7. It has been argued that, because a corporation or partnership can only act through its agents, the acts of agents in violation of the antifraud provisions are the acts of their principals. SEC Brief, supra, at 12 n.7. The term "person," however, is also used throughout the controlling persons provisions. See supra notes 1 & 3 and accompanying text. There is no separate definition of "controlling person" in the definitional sections of the Acts or any limitation of the words to natural persons. Thus, there is no justification for reading the word, "person," expansively in the antifraud provisions and reading it restrictively in the controlling persons provisions. In fact courts have held corporations to be subject to § 20(a), e.g., Henricksen v. Henricksen, 640 F.2d 880, 884-885 (7th Cir.), cert. denied, 50 U.S.L.W. 3462 (U.S. Dec. 8, 1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 712 (2d Cir.), cert. denied, 449 U.S. 1011 (1980), as well as to § 15. E.g., Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967), cert. dismissed, 393 U.S. 801 (1968). Moreover, the legislative history of the controlling persons provisions makes clear that a broad range of "persons" are within their scope. See infra pt. I(B).


29. Id. at 1211 n.27. First, the opinion cited the House Conference Report on the 1933 Act. H.R. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933). This report reads: "The Senate amendment contained provisions referred to as 'dummy provisions' which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other." Id. (emphasis added). This language does not exclude the ordinary employment situation. The next citation to legislative history is to a very general paraphrase of the 1934 Act's controlling persons section and its good faith provision. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 37, 42 (1934). The court went on to cite a House report that contains a draft of the controlling persons provision of the 1934 Act along with an explanation of control that very clearly goes against the interpretation of the section that the court adopted. This report reads: "It was thought undesirable to attempt to define [control]. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934) (emphasis added). The plain meaning of the report's language is that agency relationships are among those which fall within the definition of control. The next citation is to the SEC Brief which had preceded *Johns Hopkins* in developing this interpretation of legislative history. SEC Brief, supra note 15, at 13-17. Finally, the court cited an article in the Congressional Record that advocated passage of the
relating to ‘controlling’ persons applies to the employer (brokerage house)—employee relationship.”

Accordingly, liability was found to be governed solely by the common law. The Johns Hopkins conclusion that an employer may be liable for the misconduct of its employees under agency principles was adopted in SEC v. Management Dynamics, Inc. The court in Management Dynamics relied on legislative materials cited by the Johns Hopkins court, but conducted an independent examination of the legislative history. Specifically cited was a comment by one of the principal architects of section 20(a) that the section’s purpose was “to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section.” Disclaiming any affirmative decision with respect to the application of the controlling persons provisions to employer-employee situations, the court determined that sections 15 and 20(a) were not preemptive of common-law principles. The holding was limited to its facts, using precedent that applied agency law to the brokerage context.

In Marbury Management, Inc. v. Kohn, the Second Circuit acknowledged that section 20(a) was broad enough to cover employer liability but, citing Management Dynamics, held that agency principles were not displaced by the statutory scheme. In concluding that section 20(a) liability supplemented, rather than supplanted, traditional common-law remedies, Marbury Management implicitly adopted the Management Dynamics rationale that the controlling persons sections were aimed at situations in which there are technical

proposed legislation, because among its other advantages, it would prevent “dummy directors” from insulating controlling shareholders from liability. Flexner, The Fight on the Securities Acts, 78 Cong. Rec. 523, 529 (1934) [hereinafter cited as The Fight].


31. Id. at 1212.
32. 515 F.2d 801 (2d Cir. 1975).
33. Id. at 812; see supra note 29.
34. 515 F.2d at 812.
35. Id. (quoting Hearings, supra note 3, at 6571 (statement of Thomas G. Corcoran)).
36. Id. at 812-13.
37. Id.
38. Id. at 813.
40. Id. at 712. The complaint presented to the district court alleged only an aiding and abetting claim, and the district court confined its opinion to that claim. Marbury Management, Inc. v. Kohn, 470 F. Supp. 509, 515 n.11 (S.D.N.Y. 1979). The appellate court held, however, that the record fairly presented a claim under theories of respondeat superior and statutory controlling person liability. 629 F.2d at 712.
41. 629 F.2d at 716.
barriers to imposition of liability, such as in the case of dummy directors.  

While *Johns Hopkins, Management Dynamics* and their progeny are correct in identifying one of the concerns of the drafters of sections 15 and 20(a), they are incorrect in mistaking that concern as the limit of the provisions' respective scope. An examination of the legislative history of section 15 of the 1933 Act and section 20(a) of the 1934 Act shows that they were meant to include employment relationships.

B. Legislative History

The original draft of section 15 of the 1933 Act would have imposed liability on those who committed violations of the Acts through so-called "dummies." The definition of a "dummy" was extremely broad and included any person who is "under moral or legal obligation to act therein in accordance with the direction of another." In the final draft, the word "dummy" was dropped, and the section was rewritten to impose liability upon a person who exercises control over a violator of the Act by means of "stock ownership, agency, or otherwise." The words "stock ownership" were clearly addressed to the problem of dummy directors, members of corporate boards of directors who might violate the Act at the direction of the majority shareholders of a corporation. The drafters were particularly concerned that such shareholders not escape liability by relying on the right of directors to act independently.

42. *Id.*

43. In recent years, many courts have concluded under varying rationales that both agency principles and statutory provisions may be used to establish an employer's liability without examining the original contention that the former are available because the latter are not. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1116-19 (5th Cir. 1980) (it is the rule in other circuits); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 714-15 (2d Cir.) (same), cert. denied, 449 U.S. 1011 (1980); Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976) (same); Fey v. Walston & Co., 493 F.2d 1036, 1051-52 (7th Cir. 1974) (assuming matter is settled law); Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir.) (it is opinion of SEC), cert. denied, 398 U.S. 958 (1970); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 214 (D. Mass. 1978) (public policy of protecting investors).

44. *See infra* note 50 and accompanying text.

45. *See infra* text accompanying notes 51-54.


47. *Id.* at 2979.


Section 15, however, goes beyond its resolution of the "stock ownership" problem and imposes liability on those whose control derives from an agency relationship or, as evidenced by the use of the sweeping term "otherwise," those whose control derives from any other means. Congress was concerned that the use of "agency" might be construed as limiting the application of the section to parties who would have been principals at common law. This explains the inclusion of "otherwise" in the statute. Thus, properly construed, the section imposes liability on: (1) majority shareholders for the statutory violations of dummy directors; (2) persons who at common law would be considered principals; and (3) any other person in control of another in a manner not directly addressed by the statute.

The drafters of the 1934 Act intended to create a broad secondary liability for violations of that Act equivalent to section 15 liability for violators of the 1933 Act. Legislative history indicates that section 20(a) of the 1934 Act was consciously modeled on section 15 of the 1933 Act. Congress had the same concern in drafting the section as had the Congress that passed the 1933 Act. It wished to provide for secondary liability in the statute without including any language in the provision that might be construed as narrowing its application. Congress also decided not to define "control" to prevent any definition from being construed as a limitation on liability. Consistent with this intent, the more general phrase "directly or indirectly" was substituted for the phrase "by or through stock ownership, agency, or otherwise" used in the 1933 Act. Thus, the recurring theme of the legislative history of section 20(a) of the 1934 Act, like that of section 15 of the 1933 Act, is that the section's scope is intended to be broad.

It is axiomatic that the relationship of an employer to his employee is that of a principal to an agent. Therefore, an employer is clearly liable under the controlling persons sections of the Acts for the statut-
tory violations of his employees. Moreover, the controlling persons provisions, with their good faith defense, should be the exclusive basis for secondary liability in the federal courts. Judicial application of principles of agency to impose secondary liability on employers for the securities violations of their employees is a constitutionally infirm act of creating federal common law.

II. Federal Common Law

An assessment of the propriety of basing secondary liability under the securities acts on agency principles necessarily entails a discussion of the doctrine of separation of powers. Congress is the principal law-making body of the federal government. Congress exercises this authority in its enactment of federal statutes. Congress has expressed its will regarding securities law through enactment of the 1933 Act and the 1934 Act. These Acts provide controlling persons with specific defenses. The trend in federal courts to apply agency theories as well as the statutory sections to determine secondary liability deprives such persons of those defenses. Courts are, therefore, effectively rewriting the statutes, substituting their own judgment for that of Congress. Such judicial overreaching eviscerates the controlling persons sections and violates the boundaries imposed on the federal judiciary by the doctrine of separation of powers.

In enforcing statutes, federal courts have a limited competence to create common law, generally referred to as interstitial federal com-

62. See supra notes 5-6, 8 and accompanying text.
65. See cases cited supra note 64.
67. See supra notes 9-10 and accompanying text.
68. See supra note 7 and accompanying text.
69. See supra notes 9-14 and accompanying text.
by means of which courts may fill a gap in a federal statute. The instances in which a federal court may create such law, however, are few and exceptional. The Supreme Court has recently stated, "[t]he establishment of ... a self-consciously comprehensive program by Congress ... strongly suggests that there is no room for courts to attempt to improve on that program with federal common law."

The securities acts are, unquestionably, a comprehensive scheme of federal legislation. Therefore, a court must begin its examination of those acts with the assumption that there are no gaps in the acts, and any secondary liability under those acts must be determined under one of the provisions of the acts themselves. Nevertheless, the first proponents of the theory that agency principles may be used in such actions based their conclusion on their perception of gaps, or "interstices," in the statutes with respect to secondary liability.


73. See cases cited supra note 71. For example, section 10(b) of the 1934 Act prescribes no statute of limitations for the bringing of an action under that section. See 15 U.S.C. § 78j (1976). Federal courts have generally filled this gap in the statute by looking to the statute of limitations prescribed for similar actions by the state in which the action is brought. E.g., Robertson v. Seidman & Seidman, 609 F.2d 583, 586 (2d Cir. 1979); Fox v. Kane-Miller Corp., 542 F.2d 915, 917 (4th Cir. 1976); Nickels v. Koehler Management Corp., 541 F.2d 611, 613 (6th Cir. 1976), cert. denied, 429 U.S. 1074 (1977); Cole v. Alodex Corp., 533 F.2d 372, 373 (8th Cir. 1976) (per curiam); Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013, 1015 (5th Cir. 1976), cert. denied, 429 U.S. 1042 (1977); Posner v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 499 F. Supp. 972, 982 (S.D.N.Y. 1979).


78. The SEC Brief, supra note 15, advanced an explicit interstitial federal common law argument and determined that there were gaps in the controlling persons
in SEC v. Management Dynamics, Inc., however, imposed agency liability without resolving the question of the coverage of the controlling persons sections. Later cases such as Marbury Management, Inc. v. Kohn have not dealt with the question of a statutory gap as a prerequisite to the use of federal common law. Because these later cases have failed to identify a gap in the statutes, their application of federal common law is unwarranted.

No court has dealt with the federal common law issues implicated by the use of agency principles in securities fraud cases. The cases that hold employers liable under agency principles on the premise that employers are not covered by the controlling persons sections, however, mandate a thorough federal common law analysis. If a federal court were to find ambiguity in the legislative history of these sections, such ambiguity should be resolved in favor of the assumption that there is no gap in the statute. If a court finds no ambiguity in the legislative history and concludes that employers are not covered by the controlling persons sections, however, there would, indeed, be such a gap.

provisions as they did not cover employers. Id. at 19. In Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1211-12 & n.27 (D. Md. 1968), aff’d in part, rev’d in part, 422 F.2d 1124 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974), the court also concluded that employers were not covered and cited the SEC Brief approvingly. The Johns Hopkins court thus implicitly adopted the SEC Brief’s position regarding federal common law.

79. 515 F.2d 801 (2d Cir. 1975).
80. Id. at 812-13.
85. See supra note 83.
Assuming, *arguendo*, that the securities laws do not deal with secondary liability of employers, the issue is whether a federal court has competence to fashion federal common law. The resolution of this issue depends on whether the federal interest in the litigation is sufficient to warrant the creation of federal common law and the resulting displacement of any existing state law. The sufficiency of a federal interest is determined by whether a "clear and substantial interest" of the federal government is threatened with "major damage" by the application of state law. There are no clear judicial guidelines for determining what constitutes a "clear and substantial interest" or "major damage" to that interest. The two factors that the Supreme Court has looked to in addressing these questions, however, are the need for uniformity in the area and the degree to which there is "significant conflict" between state law and a federal policy or interest.

In assessing the sufficiency of a federal interest, a strong presumption exists that displacement of state law is not warranted. In *Erie Railroad v. Tompkins*, the Supreme Court recognized that this presumption in favor of state law is deeply rooted in our federal system. The presumption has been recently reinforced by the Supreme Court in *City of Milwaukee v. Illinois & Michigan*, where the court stated that "[i]f state law can be applied, there is no need for federal common law; if federal common law exists, it is because state law cannot be used." State law can be used in securities cases. State common-law actions are specifically preserved by the savings clause of the securities acts, section 28(a) of the 1934 Act. The purpose of the securities laws is to regulate conduct in the financial community. The existence of a savings clause indicates that the drafters of the Acts did not believe that this purpose is in "significant conflict" with the availability of state common-law actions against

92. 304 U.S. 64 (1938).
93. See id. at 78.
95. Id. at 1790 n.7.
97. See supra note 16 and accompanying text.
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brokerage firms for fraud, deceit or misrepresentation. Furthermore, it is clear from the inclusion of the savings clause that the drafters did not believe that any lack of uniformity in state law would inhibit the purpose of the Acts. Therefore, assuming the absence of secondary liability for employers under the securities acts, an aggrieved party may proceed against a brokerage firm only under state law.\(^9\)

Arguably, the application of state law by a federal court in exercise of pendent jurisdiction over a state claim\(^9\) may lead to the same result as application of federal common law. This situation may give rise to the assertion that the distinction is procedural rather than substantive. There are, however, substantive differences between federal securities laws and the laws of the states with respect to fraud\(^10\) and secondary

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liability. In addition, state law in these areas is unsettled and diverse. State law cannot, therefore, be summarily supplanted by federal common law for purposes of judicial economy or convenience.

Even if a court were to find a federal interest sufficient to justify the creation of interstitial federal common law, it would have to fashion


such common law in a manner consistent with the intent of Congress in enacting the statute. It is clear that Congress was seriously concerned, in enacting the securities acts, that a party's liability be related to his fault. This is evident from the good faith defense available under section 20(a) of the 1934 Act and the scienter requirement of section 15 of the 1933 Act. The "due diligence" defense available to defendants under the 1933 Act further supports this conclusion. Courts have recognized the appropriateness of relating liability to fault in their requirements of various degrees of scienter for various forms of Rule 10b-5 liability.

There is no good faith defense available to a principal at common law. The imposition of liability on employers under principles of agency, therefore, would amount to an imposition of strict liability on employers, contrary to the intent of Congress that liability be related to fault. If it is determined appropriate to create interstitial federal common law in this area, provision must be made for a relation of liability to fault.

The courts in Marbury Management, Inc. v. Kohn and Paul F. Newton & Co. v. Texas Commerce Bank advanced one other argument in support of their imposition of liability under principles of respondeat superior. The courts reasoned that such a result was required by section 28(a) of the 1934 Act, which states that all rights and remedies under the 1933 Act and the 1934 Act shall be in addition to rights and remedies otherwise available. The legislative history

105. 15 U.S.C. § 78t(a) (1976); see supra note 9 and accompanying text.
106. 15 U.S.C. § 77o (1976); see supra note 10 and accompanying text.
110. See supra notes 11-14 and accompanying text.
112. See supra notes 105-09 and accompanying text.
113. 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).
114. 630 F.2d 1111 (5th Cir. 1980).
115. Id. at 1118; Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).
117. Id.
surrounding this section is unmistakably clear in stating that the section is intended to preserve only state rights and remedies. Courts have construed the section as primarily intended to preserve state blue-sky law. Further, a court might assume that section 28(a) was intended to preserve federal common law as the passage of the Acts antedates the general proscription of federal common law by *Erie Railroad v. Tompkins*. Such an assumption, however, is contrary to the presumption recently enunciated by the Supreme Court in *City of Milwaukee v. Illinois & Michigan* that the need for federal common law no longer exists when a field has been made the subject of comprehensive federal legislation. A contrary assumption is applied to state common law, which is presumed to survive the enactment of federal legislation covering an area. An action under the controlling persons provisions of the federal securities acts, however, is a federal statutory action in which common law concepts, be they of federal or state origin, have no application.

**CONCLUSION**

Section 15 of the 1933 Act and section 20(a) of the 1934 Act are the sole appropriate means by which to impose secondary liability under the securities acts. Cases that hold to the contrary and impose liability under principles of agency law go against the plain meaning of both sections and are in conflict with congressional intent that parties who are not at fault should have an affirmative defense to liability under the securities acts. The use of agency principles to determine liability under the securities laws is an inappropriate creation of federal common law and runs directly against the principles of the federal *Erie* doctrine.

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118. *Hearings, supra* note 3, at 6577, 6640, 6724.
120. 304 U.S. 64, 78 (1938).
122. *Id.* at 1791.
123. *Id.* at 1792 & n.9; see *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977); *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).