

**THE EIGHTH CIRCUIT AND SECONDARY LIABILITY  
UNDER THE 1933 AND 1934 SECURITIES  
ACTS—METGE v. BAEHLER**

INTRODUCTION

Securities fraud litigation has experienced “explosive growth” in the last twenty years.<sup>1</sup> The primary source of securities fraud litigation has been the application of Securities and Exchange Commission Rule 10b-5 (“Rule 10b-5”).<sup>2</sup> Neither the federal securities statutes

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1. Ruder, *Multiple Defendants In Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicta, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 598 (1972) (prominent article concerning aiding and abetting liability under federal securities law) [hereinafter cited as Ruder, *Multiple Defendants*]. During the period of 1946 to 1962, only 54 cases were decided under Rule 10b-5. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 687-90 (1963). But “since that time the volume of litigation has grown to well over 100 reported cases each year.” Ruder, *Multiple Defendants, supra*, at 598 n.1.

2. 17 C.F.R. § 240.10b-5 (1985). 1 A. BROMBERG, *SECURITIES LAW & FRAUD* § 2.2(460) (1974). Rule 10b-5 was promulgated in 1942. *Id.* § 2.2(410) (citing SEC Sec. Exch. Act Release No. 3230 (May 21, 1942)). Even though its primary application has been in misrepresentation and nondisclosure scenarios during the purchase and sale of securities, Rule 10b-5 has been successfully used to challenge mergers, liquidations, purchase and sale of control, corporate acquisitions, and sales of securities or other business combinations. *See, e.g.*, *Alley v. Miramon*, 614 F.2d 1372, 1376 (5th Cir. 1980) (minority shareholder fraudulently induced to transfer stock certificate without receiving liquidation proceeds); *Goldberg v. Meridor*, 567 F.2d 209, 209 (2d Cir. 1977) (shareholder derivative suit alleging deceit and misconduct by board of directors on both sides of a share exchange pursuant to a corporate merger), *cert. denied*, 434 U.S. 1069 (1978); *Coffee v. Permian Corp.*, 434 F.2d 383, 385 (5th Cir. 1970) (minority shareholder who was forced to sell during liquidation entitled to sue under Rule 10b-5), *aff'd on remand*, 474 F.2d 1040, *cert. denied*, 412 U.S. 920 (1973); *Mader v. Armel*, 402 F.2d 158, 159 (6th Cir.) (minority shareholders “cashed out” during a merger entitled to sue under Rule 10b-5), *cert. denied*, 394 U.S. 930 (1968). Other corporate transactions that may give rise to a shareholder derivative claim under Rule 10b-5 include a corporate repurchase of shares at an inflated price or an additional issuance of corporate shares on an unfavorable basis. *See, e.g.*, *Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602, 603 (5th Cir. 1979) (repurchase of shares); *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241, 1241 (5th Cir. 1971) (issuance of shares); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 198 (5th Cir. 1960) (issuance of shares), *cert. denied*, 365 U.S. 814 (1961). Brokers, dealers, attorneys, trustees, accountants, and purchaser representatives with special duties to their customers, and even customers, have been subjected to judicial scrutiny under Rule 10b-5. *See, e.g.*, *Norris v. Wirtz*, 719 F.2d 256, 256-57 (7th Cir. 1983) (trust beneficiary qualifies as a seller and can sue under Rule 10b-5 to challenge a purchase of stock by the trustee from the trust); *Stokes v. Lokken*, 644 F.2d 779, 780 (8th Cir. 1981) (attorney not an aider and abettor of violations of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5); *Hecht v. Harris, Uphams & Co.*, 430 F.2d 1202, 1202 (9th Cir. 1976), *modifying & aff'g* 283 F. Supp. 417 (N.D. Cal. 1968) (broker-dealer duties to customers enforced under Rule 10b-5). *See also* *Schoenbaum v. Firstbrook*, 405 F.2d 200, 212 (2d Cir. 1968) (holding that trust beneficiaries have standing to sue under Rule 10b-5 based on the derivative injury to the beneficiary), *cert. denied*, 395 U.S. 906 (1969). Account-

nor Rule 10b-5 specifically provide for secondary liability.<sup>3</sup> However, the various theories of secondary liability, including aider-abettor and controlling person liabilities, have been recognized in the federal courts for forty years.<sup>4</sup> In recent years, secondary liability has risen in importance because the primary violator in the normal securities fraud litigation is often bankrupt or nearly insolvent.<sup>5</sup> Furthermore, recent United States Supreme Court decisions have begun to retract the scope of section 10(b) of the Securities Exchange Act of 1934<sup>6</sup> and

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ant liability has been the subject of important securities fraud litigation. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 188 (1976); Landy v. FDIC, 486 F.2d 139, 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Wessel v. Buhler, 437 F.2d 279, 280 (9th Cir. 1971), SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Customers also have felt Rule 10b-5's bite. *See* A.T. Brod & Co. v. Perlow, 375 F.2d 393, 395 (2d Cir. 1967) (action by broker against customer for fraudulent failure to pay for securities ordered).

3. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80, 80 n.4 (1981). Professor Fischel has interpreted secondary liability under the securities laws to have two distinct meanings:

First, the term is used to describe the judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer. Courts have imposed this type of secondary liability on defendants who aid and abet, conspire with, or employ a defendant who does violate the express prohibition of a statute. . . .

The second usage of the term secondary liability is the liability expressly imposed on "controlling persons" by § 15 of the Securities Act of 1933, [15 U.S.C. § 77a-77bbbb (1982)] and § 20(a) of the Securities Exchange Act of 1934, [15 U.S.C. §§ 78a-78kk (1981)].

*Id.*

4. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). A private right of action is not expressly provided for in Rule 10b-5. *Id.* Such a right of action was first implied in Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946). The Kardon court predicated the existence of an implied private right of action for damages under § 10(b) and Rule 10b-5 upon the tort law maxim, *ubi jus, ibi remedium*—where there is a right, there is a remedy. *Id.* *See also* Cannon v. University of Chicago, 441 U.S. 677, 692 (1979) (noting that the Rule 10b-5 remedy has had 25 years of judicial recognition).

5. *See* R. JENNINGS & H. MARSH, JR., *SECURITIES REGULATION CASES AND MATERIALS* 1134 (5th ed. 1982) [hereinafter cited as JENNINGS & MARSH]. Professor Jennings and Mr. Marsh offer the following insight:

[Aider-abettor] doctrines have become of enormous importance in the last few years because of the fact that in many cases the wrongdoer is insolvent or bankrupt and because of the practice of plaintiff's counsel in suing everyone, no matter how remotely connected with the transaction, who might have the ability to pay the judgment.

*Id.* *See also* Landy, 486 F.2d at 143-44. The president of a bank stole money from the bank and thereby injured its stockholders. The plaintiff sued (1) the bank president, (2) 12 brokerage firms who executed stock transactions for the bank president, (3) 16 individuals employed at the brokerage firm, (4) the New York Stock Exchange, (5) the National State Bank of Elizabeth (a different bank entirely), (6) a firm of certified public accountants, (7) the Federal Reserve Bank of New York, and (8) the Federal Deposit Insurance Corporation. *Id.* Professor Jennings and Mr. Marsh said of the Landy case: "This is a relatively modest example of people being sued in these federal securities law cases." R. JENNINGS & H. MARSH, JR. *supra*, at 1134 n.15.

6. 15 U.S.C. § 78j (1982).

Rule 10-b.<sup>7</sup> Therefore, a plaintiff is encouraged to sue all parties involved in the distribution or sale of securities who may have had any contact with the primary violator, thereby increasing the probability of a successful cause of action against at least one solvent defendant.<sup>8</sup>

In *Metge v. Baehler*,<sup>9</sup> the Court of Appeals for the Eighth Circuit ruled that a bank which acted as a primary lender for a company that allegedly committed securities fraud could be liable as an "aider and abettor" of the fraud.<sup>10</sup> However, the court rejected the plaintiff's argument that the bank could also be liable as a "controlling person."<sup>11</sup>

This Comment examines the Eighth Circuit's decision in *Metge* in light of the legislative history and common law development of section 15 of the Securities Act of 1933,<sup>12</sup> sections 10(b) and 20(a) of the Securities Exchange Act of 1934,<sup>13</sup> and Rule 10b-5.<sup>14</sup> The Comment illustrates how the court's decision in *Metge* expands the scope of both aiding-abetting liability in private securities fraud litigation and the doctrine of controlling person liability.<sup>15</sup> The court's decision in *Metge* renders banks virtually insurers of their customers who issue securities.

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7. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (holding that only purchasers and sellers in an alleged fraudulent transaction have standing to sue under Rule 10b-5, thereby maintaining solid resistance to broaden Rule 10b-5's scope). Prior to 1975, the Supreme Court expressed its willingness to expand § 10(b)'s and Rule 10b-5's availability to injured plaintiffs. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). See also *Herman & MacLean*, 459 U.S. at 376 (§ 11 of the 1933 Act and Rule 10b-5 present cumulative remedies). But see *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 463 (1977) (stating that in order to state a Rule 10b-5 claim the plaintiff must show an element of "deception"); *Ernst & Ernst*, 425 U.S. at 194 n.12 (holding that private plaintiff must prove "scienter" and that mere negligence is not sufficient to impose liability under Rule 10b-5).

8. See *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974). Part of Rule 10b-5's success can be directly attributed to its ability to reach remote defendants in the plaintiff's quest for "deep pockets." For example, aider-abettors as well as conspirators are valuable codefendants because they are jointly and severally liable with primary violators. See *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 151-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

9. 762 F.2d 621 (8th Cir. 1985), *aff'g in part and rev'g and remanding in part* 577 F. Supp 810 (S.D. Iowa 1984), *cert. denied*, 106 S. Ct. 798 (1986).

10. *Id.* at 630, 632.

11. *Id.* at 631-32.

12. 15 U.S.C. § 77o (1982).

13. 15 U.S.C. §§ 78j(b), 78t (1982).

14. 17 C.F.R. § 240.10b-5 (1985).

15. Everything said about aider-abettor and control person liability in *private securities fraud* litigation under § 10(b) and Rule 10b-5 should apply *a fortiori* to *public enforcement* actions brought by the SEC. See *Aaron v. SEC*, 446 U.S. 680, 695 (1980) (holding that the scienter standard applies under Rule 10b-5 regardless of whether the action is one for damages or an enforcement action brought by the SEC).

## FACTS AND HOLDING

Thelma Metge and Elizabeth Shepard brought suit on behalf of themselves and 635 other individuals similarly situated against Bankers Trust Company ("BTC") and seventeen individuals.<sup>16</sup> The plaintiffs brought suit in the United States District Court for the Southern District of Iowa, alleging a state common law fraud action and violations of federal securities laws stemming from misrepresentations and the nondisclosure of relevant facts in connection with the sale of securities.<sup>17</sup> Specifically, the plaintiffs alleged that BTC was liable for violations of section 10(b) and Rule 10b-5 on theories of aiding and abetting, conspiracy, and controlling person liability.<sup>18</sup> The plaintiffs contended that BTC was liable as an aider and abettor with Investor's Equity, Inc., ("IEI") an Iowa real estate company involved in servicing real estate contracts on low cost homes.<sup>19</sup>

In 1969, IEI was forced by fluctuating business conditions to form a company that would raise capital by selling unregistered, unsecured, one-year renewable securities called thrift certificates.<sup>20</sup> In mid-1974, Iowa banned the sale of unregistered thrift certificates.<sup>21</sup> Shortly thereafter, when IEI declared bankruptcy, certificate holders received only twelve and one-half cents on each dollar of accrued interest and no repayment of principal.<sup>22</sup> BTC lost approximately \$650,000 in principal and interest on its loans to IEI and IEI's subsidiaries.<sup>23</sup> The district court granted BTC's motion for summary judgment after examining the four separate theories that were the cornerstones of the plaintiffs' case.<sup>24</sup> On appeal, the plaintiffs argued that the district court erred on the facts and law regarding BTC's liability as an aider-abettor and as a controlling person, and that the court abused its discretion in dismissing pendent state claims against BTC.<sup>25</sup>

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16. *Metge*, 577 F. Supp. at 812.

17. *Id.*

18. *Id.*

19. *Id.* at 813.

20. *Id.* at 813-14.

21. Act of Apr. 25, 1974, ch. 1238, § 14, 65th G.A., 1974 Iowa Acts 823, 829, *repealed by* Act of July 18, 1975, ch. 234, § 621, 66th G.A., 1975 Iowa Acts 516, 547.

22. *Metge*, 577 F. Supp. at 813.

23. *Id.* at 814. As a result of IEI's insolvency, BTC lost \$543,703.00 in principal and \$107,809.00 in accrued interest on its various loans to IEI. *Id.* The foregoing breakdown was a prominent consideration in the Eighth Circuit's reversal of the district court's grant of summary judgment. *See Metge*, 762 F.2d at 629-30.

24. *Metge*, 577 F. Supp. at 825. In their amended complaint, the plaintiffs asserted claims against BTC under three theories of secondary liability: (1) controlling person; (2) aiding and abetting; and (3) conspiracy. *Id.* at 812. In addition, plaintiffs alleged various state law violations. *Id.* On appeal, the plaintiffs dropped the conspiracy theory of secondary liability. *Metge*, 762 F.2d at 624.

25. *Metge*, 762 F.2d at 623.

The Eighth Circuit ruled that the plaintiffs produced sufficient evidence which, taken as a whole, "presented what should have been a jury issue on the question of aiding-and-abetting liability."<sup>26</sup> In reinstating the certificate holders' federal securities fraud claims, the court also reversed the dismissal of pendent state law fraud claims arising from the same alleged misconduct.<sup>27</sup>

The court ruled that aiding and abetting charges based on the inaction of a secondary party must meet a high standard of intent.<sup>28</sup> The court framed the issue as whether the bank knew that the certificates were worthless and whether it prolonged the life of the failing company for its own benefit at the certificate holders' expense.<sup>29</sup> In addressing these questions, the Eighth Circuit reviewed the three-part test for aiding-and-abetting liability developed at common law: "(1) the existence of a securities law violation by the primary party (as opposed to the aiding-and-abetting party); (2) 'knowledge' of the violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation."<sup>30</sup> In the Eighth Circuit's view, the elements of "knowledge of the violation" and "'substantial assistance' by the aider and abettor" are inversely related to one another.<sup>31</sup> Thus, if evidence of substantial assistance is weak, there must be a greater showing of knowledge of the violation.<sup>32</sup>

Regarding the "substantial assistance" element, the court noted that BTC's involvement amounted to inaction rather than positive acts.<sup>33</sup> Many courts agree that if the aider and abettor owes an independent duty to act or to disclose a securities violation, then inaction can be a proper basis for liability under the substantial assistance test.<sup>34</sup> However, the district court and the Eighth Circuit found no duty to disclose or to act in *Metge*.<sup>35</sup>

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26. *Id.* at 630.

27. *Id.* at 632.

28. *Id.* at 625.

29. *Id.*

30. *Id.* at 624. The Eighth Circuit had previously set forth the three-pronged test to establish aiding-and-abetting liability in *Stokes v. Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981). See notes 347-56 and accompanying text *infra*.

31. *Metge*, 762 F.2d at 624 (citing *Stokes*, 644 F.2d at 784; *Woodward v. Metro Bank*, 522 F.2d 84, 95 (5th Cir. 1975)).

32. *Id.*

33. *Id.*

34. See, e.g., *Cleary v. Perfectune*, 700 F.2d 774, 778 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 925-26 (2d Cir. 1980); *Woodward*, 522 F.2d at 96; *SEC v. Coffey*, 493 F.2d 1304, 1316-17 (6th Cir. 1974); *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973); *Brennan*, 417 F.2d at 154-55; *Quintel Corp., N.V. v. Citibank, N.A.* 589 F. Supp. 1235, 1244-45 (S.D.N.Y. 1984); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 713 (D.D.C. 1978).

35. *Metge*, 762 F.2d at 624. See also *Metge*, 577 F. Supp. at 821.

The Eighth Circuit found that the district court had properly applied the *Woodward-Monsen* rule.<sup>36</sup> The *Woodward-Monsen* rule requires that, in a case based on the inaction of the secondary party where there is no duty to disclose or to act, a high standard of intent on the part of the aider and abettor must be shown.<sup>37</sup> The Eighth Circuit interpreted *Woodward v. Metro Bank*<sup>38</sup> and *Monsen v. Consolidated Dressed Beef*<sup>39</sup> as necessitating "that the aider-abettor's inaction be accompanied by actual knowledge of the underlying fraud and intent to aid and abet a wrongful act."<sup>40</sup> Furthermore, the court stated that the requisite intent and knowledge could be satisfied by circumstantial evidence.<sup>41</sup>

Although expressing no opinion on the ultimate outcome of the litigation, the Eighth Circuit concluded that it would be premature to rule as a matter of law that the bank could not be liable as an aider and abettor.<sup>42</sup> The court held that the certificate holders adduced enough evidence to avoid summary judgment on the issue of aiding and abetting the securities fraud.<sup>43</sup> To reach this decision the court ascertained the extent of BTC's knowledge by examining the nature of the relationship between BTC and IEI.<sup>44</sup>

Beginning in 1970, BTC acquired by foreclosure a controlling block of stock in Mid-Iowa Lakes Corporation ("MIL"), which developed recreation real estate outside Des Moines, Iowa.<sup>45</sup> In February of 1971, BTC sold the MIL stock to IEI for \$950,000.<sup>46</sup> IEI paid \$131,000 in cash, gave BTC a \$575,000 collateral pledge note for the acquisition loan, 50,000 shares of IEI stock, an irrevocable, unlimited, but qualified proxy to vote the MIL stock, and \$440,000 in personal guarantees by IEI directors on the acquisition loan.<sup>47</sup> As part of the

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36. *Metge*, 762 F.2d at 625.

37. *Id.* (citing *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978), *cert. denied*, 434 U.S. 930 (1979)). In *Monson*, the Third Circuit evaluated the substantial assistance requirement in a case of inaction and concluded that inaction "may provide a predicate for liability where the plaintiff demonstrates that the aider-abettor consciously intended to assist in the perpetration of the wrongful act." *Id.* See also *Woodward*, 522 F.2d at 97. In *Woodward*, the court stated: "When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter." *Id.* (citation omitted).

38. 522 F.2d 84 (5th Cir. 1975).

39. 579 F.2d 793 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1979).

40. *Metge*, 762 F.2d at 625.

41. *Id.* (citing *Woodward*, 522 F.2d at 96).

42. *Id.*

43. *Id.*

44. *Id.* at 625-30.

45. *Id.* at 625.

46. *Id.* at 626.

47. *Id.* The court stated: "The 50,000 shares of IEI stock (the largest block of out-

initial agreement, BTC received quarterly financial reports on IEI which revealed large thrift certificate balances.<sup>48</sup> In examining BTC's relationship with IEI, the Eighth Circuit pointed to a number of factors that, when viewed separately, were "unremarkable events in the turbulent economy of the early seventies; but viewed in conjunction with the other evidence . . . suggest an unusual pattern of extraordinary attempts to prolong IEI's financial viability."<sup>49</sup> First, the court inferred that BTC knew that IEI depended on cash from the sale of "then worthless thrift certificates" to make payments on its obligations to BTC.<sup>50</sup> Evidence indicated that BTC directly received thrift certificate proceeds from IEI to make payments on the outstanding loans with BTC.<sup>51</sup> Second, on four separate occasions BTC refinanced the original acquisition loan "with the declared objective of preserving the enterprises."<sup>52</sup> The Eighth Circuit observed that, even though BTC had lost more than \$650,000 through IEI's insolvency, this loss had to be compared with that of the certificate holders, who had received none of the \$1.5 million principal to which they were entitled.<sup>53</sup> Furthermore, BTC's initial exposure in the lending arrangement was \$950,000, suggesting that it had received "significant" payments of principal and interest because of IEI's

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standing IEI stock, amounting to seventeen to eighteen percent of total shares) were transferred to Bella and Company, which was a partnership of senior BTC officers." *Id.* Furthermore, a proviso in the proxy held that BTC could vote the MIL stock if IEI was in default in its payments on the acquisition loan. *Id.* From the outset of the agreement BTC had "at least potential control" because IEI was constantly behind on its payments. *Id.*

48. *Id.*

49. *Id.*

50. *See id.* at 627-28. Evidently, the court presumed that such knowledge could have been gleaned from a careful analysis of IEI's financial statements, which were available to BTC. *See id.* at 628.

51. *Id.* at 627. BTC's role as escrow agent for IEI in an exchange of other obligations for thrift certificate guaranty bonds "demonstrat[es] its awareness of IEI's reliance on the thrift certificate program in April, 1972." *Id.* Furthermore, the court noted that a bank officer received a hand-delivered check from an IEI subsidiary charged with raising the capital from the thrift certificate sales, an IEI deposit slip for the \$30,000.00 check, and an IEI check for \$30,000.00 payable to BTC. *Id.* at 629. The bank officer then signed a receipt for the deposit and personally credited the IEI account for the next day. *Id.* The Eighth Circuit stated, "We regard the evidence of the transaction as potentially probative of BTC's actual knowledge as we survey the totality of the evidence." *Id.*

52. *Id.* at 627. Under the terms of the initial acquisition loan, IEI was obligated to make a \$100,000.00 downpayment and quarterly payments of \$23,000.00 until September, 1972, when a large balloon payment would be due. *Id.* IEI defaulted on its first and second payments at which time BTC arranged for a \$200,000.00 refinancing arrangement in early 1971. *Id.* at 626. BTC agreed to renew and amend the terms of the agreement in late September, 1972. *Id.* at 627. Refinancing was necessary in May, 1973, and again in March, 1974. *Id.* Thrift certificate sales ceased in May, 1974, and by the end of the summer, IEI filed for Chapter 11 bankruptcy. *Id.*

53. *Id.* at 629.

"delayed bankruptcy."<sup>54</sup> In the circuit court's view, BTC "may have been able to lever itself into a more favorable position than the holders of thrift certificates" from IEI.<sup>55</sup>

While the court concluded that summary judgment on aiding and abetting liability may have been "premature," it found that the district court properly applied a two-part test to decide that BTC was not the "controlling person" of the IEI entities within the meaning of section 15 of the 1933 Securities Act.<sup>56</sup> Recognizing that section 15's legislative history provided little guidance for the court, the Eighth Circuit looked to the common law development of controlling person liability.<sup>57</sup>

Previously, in *Myzel v. Fields*,<sup>58</sup> the Eighth Circuit had noted that section 20 of the Securities Exchange Act of 1934,<sup>59</sup> which is the progeny of section 15 of the Securities Act of 1933, is "remedial" in purpose and "is to be construed liberally."<sup>60</sup> *Myzel* held that indirect means of influence, short of actual control, are sufficient to impute controlling person liability.<sup>61</sup> The district court in *Metge* followed the *Myzel* mandate to construe section 15 liberally, while relying on

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54. *Id.*

55. *Id.* at 620.

56. *Id.* Section 15 of the 1933 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 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1982).

57. *Metge*, 762 F.2d at 630 (citing *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 941 (1968)). Congress chose not to define "control" strictly because of the difficulty of enumerating the "many ways in which control may be exerted." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934). The Eighth Circuit noted that the SEC has "adopted a similar approach in formulating a broad definition of control as '[t]he possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'" *Metge*, 762 F.2d at 630 (quoting 17 C.F.R. § 240.12(b)-2 (1983)).

58. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), *overruled on other grounds*, *Ernst & Ernst*, 425 U.S. at 193 & n.12.

59. 15 U.S.C. § 78t(a) (1982). Section 20(a) reads:

(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 violations or cause of action.

60. *Myzel*, 386 F.2d at 738.

61. *Id.*

*Stern v. American Bankshares Corp.*<sup>62</sup> to formulate the controlling person test.<sup>63</sup> In *Stern*, the court required the plaintiff to demonstrate that the alleged controlling person "actively participated" in the controlled person's operations and possessed actual control over the questionable transaction.<sup>64</sup> In compliance with the Eighth Circuit's guidance in *Myzel*, the district court established a two-point test where plaintiffs must prove: (1) the defendant-lender actually participated in the controlled person's operation in general; and (2) the defendant possessed the power to control the specific transaction or activity which is the predicate of the primary violation, but he need not prove that this power was ever exercised.<sup>65</sup> By accepting the *Stern* test, the Eighth Circuit rejected the more restrictive "culpable participation" standard, which requires proof of the defendant's actual participation in the primary violation.<sup>66</sup> The court noted that "the plain meaning of [section 15 of the Securities Act of 1933 and section 20 of the Securities Exchange Act of 1933] does not require participation in the wrongful transaction."<sup>67</sup> Furthermore, because good faith and lack of participation are affirmative defenses in a controlling person action, requiring the plaintiff to prove lack of good faith and participation "confuses the parties' responsibilities and unnecessarily burdens plaintiffs contrary to the plain meaning of the statute."<sup>68</sup>

Applying the law to the facts, the court first considered whether the certificate holders had shown that BTC exercised "actual control" over IEI's operations in general.<sup>69</sup> Because the evidence was insufficient to show that BTC actually controlled IEI, the court reasoned that it did not need to decide whether the bank had power to control the alleged conduct upon which the primary violation was predicated.<sup>70</sup> The Eighth Circuit suggested that the plaintiffs' evi-

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62. 429 F. Supp. 818 (E.D. Wis. 1977).

63. *Metge*, 577 F. Supp. at 817-18.

64. *Stern*, 429 F. Supp. at 824. The court stated: "Once that is established the matters of knowledge and actual participation, which directly or indirectly induced the fraud, are matters for the defense." *Id.*

65. *Metge*, 577 F. Supp. at 817-18.

66. See, e.g., *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 889-90 (3d Cir. 1975) (accepting the culpable participation requirement); *Gordon v. Burr*, 506 F.2d 1080, 1085-86 (2d Cir. 1974) (accepting the culpable participation requirement).

67. *Metge*, 762 F.2d at 631 (citing *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981)).

68. *Id.*

69. *Id.*

70. *Id.* at 631-32. Among the several factors cited by the plaintiffs which suggested actual control of IEI were that (1) BTC held 17% to 18% of IEI's stock with the rights inuring to stock ownership, including the right to attend stockholder meetings, to vote its stock, and to receive stockholder communications; (2) BTC influenced MIL's management through its proxy on a controlling block of 51% of MIL's voting stock

dence proved the "potential" for influence over IEI's business decision, but it could not support plaintiffs' allegation that BTC actually exercised control over the operation of the corporation in general.<sup>71</sup> Accordingly, the district court's judgment was affirmed on the controlling person theory of liability,<sup>72</sup> but it was reversed and remanded on the aiding and abetting theory and on the pendent state claims.<sup>73</sup>

## BACKGROUND

### CONTROLLING PERSON PROVISIONS

This section of this Comment provides an overview of the legislative history and case law interpretation of the controlling persons provisions. Primary considerations will be the definition of "control," the defenses to controlling persons liability, and the subtle interplay between controlling persons and common law doctrines.

Section 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934 impose joint and several liability upon controlling persons for the securities law violations of controlled persons.<sup>74</sup> Section 15 of the 1933 Act provides that persons in a control relationship with persons liable under either section 11 or 12 will be liable if the controlling person had knowledge or reason to believe in the existence of the facts constituting the violation.<sup>75</sup> Section 20(a) of the 1934 Act provides liability for any controlling person unless that controlling person acted in good faith and did not induce the violation by the controlled person.<sup>76</sup>

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which BTC retained as part of the collateral for the initial acquisition loan; (3) BTC personnel attended a few MIL and IEI board meetings; (4) BTC influenced IEI's and MIL's debt structure and internal operations due to BTC's innovative refinancing arrangements by causing IEI to issue notes, sell its receivables, and loan money to MIL; and (5) BTC's "put," the right to sell IEI stock back to IEI at a higher rate should IEI default on its obligations in the acquisition loan, influenced IEI's capital management policies. *Id.* at 631. *See also* note 47 *supra*.

71. *Metge*, 762 F.2d at 632. The court stated: "In fact, the evidence . . . mentioned exemplifies the kind of evidence that might be adduced on the second prong of the test to demonstrate possession of power to control, rather than actual control." *Id.*

72. *Id.*

73. *Id.* at 630, 632.

74. *See* notes 56, 59 *supra*.

75. *See* note 56 *supra*. Section 11 of the 1933 Act imposes civil liability for false or misleading statements in a registration statement. 15 U.S.C. § 77k (1982). Section 12 of the 1933 Act imposes civil liability for the offer or sale of a security in violation of the delivery requirements for the prospectus and registration statement found in § 5 of the same Act. In addition, civil liability arises under § 12 for the offer or sale of a security by means of a false or misleading prospectus or oral communication. 15 U.S.C. § 77i (1982). *See also id.* § 77e (1982).

76. *See* note 59 *supra*. Section 20(a)'s popularity among plaintiffs' attorneys stems from the fact that violations of the broad anti-fraud provisions of § 10(b) and Rule 10b-5 inure to controlling persons pursuant to this section, whereas secondary liability

*Legislative History of the Controlling Person Provisions*

Originally section 15 of the 1933 Act was part of the "dummy" provisions found in the initial draft of the bill proposed by the Senate.<sup>77</sup> The goal of the "dummy" provisions was to prevent any person or any entity from utilizing a "dummy"<sup>78</sup> or controlled entity to further securities law violations and escape liability for such conduct.<sup>79</sup> Therefore, the initial Senate draft required proof of a securities law violation by a "dummy" or controlled person subject to the control of another person or entity.<sup>80</sup> Once the "dummy" provisions were incorporated into the final Senate draft<sup>81</sup> serious problems arose in its application.<sup>82</sup>

By 1934 criticism arose that section 15 was "too drastic" and that it unnecessarily "interfer[ed] with business."<sup>83</sup> Furthermore, the original Senate version lacked the special defenses of "no knowledge"

under § 15 is limited to violations of § 11 and § 12 of the 1933 Act. R. JENNINGS & H. MARSH, JR., *supra* note 5, at 1143.

77. S. 875, 73d Cong., 1st Sess. § 2(k), 4, 13 (1933), *reprinted in* 77 CONG. REC. 2978, 2979, 2982 (1933). See also S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933).

78. S. 875, 73d Cong., 1st Sess. § 4, (1933), *reprinted in* 77 CONG. REC. at 2979 (defining a "dummy" as a "person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligations to act therein in accordance with the direction of another").

79. *Id.* § 13, *reprinted in* 77 CONG. REC. at 2982. This section provides in part:

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

80. *See id.*

81. *See* 15 U.S.C. § 77o (1982).

82. 78 CONG. REC. 8666, 8668 (1934). Section 15 of the 1933 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 other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.

Securities Act of 1933, ch. 38, § 15, 48 Stat. 74, 84.

83. 78 CONG. REC. 8668 (remarks of Sen. Fletcher).

or "reasonable ground" found in the current version of section 15.<sup>84</sup> In response to this criticism, the 1933 Securities Act was amended with the intention of limiting the application of section 15 to those situations where a controlling person had effectively exercised control to bring about a securities law violation.<sup>85</sup> As a result, liability will not extend to controlling persons where they have "no knowledge of or reason to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."<sup>86</sup>

At the time of the adoption of the 1933 Act amendments, Congress also enacted section 20(a) of the 1934 Act which is similar in effect to section 15.<sup>87</sup> Section 20(a) contains the special defense of "good faith," which excuses a controlling person from liability if he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."<sup>88</sup> Nowhere in the 1933 Act or 1934 Act is "control" defined; the House Report to section 20 indicates this omission was deliberate.<sup>89</sup>

During the House debate, it was suggested that the concept of control was overly vague. One Congressman stated that the object of the control provision was to "catch the man who stands behind the scenes and controls the man who is in a nominal position of authority."<sup>90</sup> Furthermore, it was stated in the debate that "[t]he man charged with control is only responsible to the extent he did control the action complained of and his actual control must be established."<sup>91</sup> A meaningful definition of "control" did not result from

84. Compare Securities Act of 1933, ch. 38, 15, 48 Stat. 74, 84, with Securities Exchange Act of 1934, ch. 404, § 208, 48 Stat. 881, 908 (codified at 15 U.S.C. § 770 (1982)).

85. 78 CONG. REC. 8669. In a memorandum prepared by Senator Fletcher explaining his recommendations to amend § 15, he stated: "The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based." *Id.* Apparently, Senator Fletcher's view prevailed. See H.R. REP. NO. 1383, *supra* note 57, at 26.

86. Securities Exchange Act of 1934, ch. 404, 208, 48 Stat. 881, 908 (codified at 15 U.S.C. § 770 (1982)).

87. Compare 15 U.S.C. § 770 (1982) with 15 U.S.C. § 78t (1982). See also T. KAZEN, THE LAW OF SECURITIES REGULATION 207 (1985).

88. 15 U.S.C. § 78t(a) (1982).

89. See H.R. REP. NO. 1383, *supra* note 57, at 26. The report provided:

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

90. 78 CONG. REC. 8086, 8095 (1934) (remarks of Rep. Lea).

91. *Id.* When pressed to define "control" further, Representative Lea offered an

the 1934 Act. Consequently, the federal judiciary has faced great difficulty in the interpretation and application of the controlling person provisions.<sup>92</sup>

*Case Law Under Sections 15 and 20(a)*

Consistent with congressional intent, the circuit courts have construed "control" broadly<sup>93</sup> and few courts have limited the categories of entities not qualifying as "controlling persons."<sup>94</sup> The best statement of the policy of broad construction is found in the oft-quoted passage from *Myzel v. Fields*.<sup>95</sup> There, the court stated: "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

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example of the tautological reasoning that is the center of confusion under 20(a): "[Control] is simply a question of putting the responsibility on the man who is really responsible." *Id.*

92. Compare *G.A. Thompson & Co.*, 636 F.2d at 957-58, 960 (rejecting culpable participation requirement under control person provisions) with *Roches Bros.*, 527 F.2d at 884-85 (requiring culpable participation under § 20(a)).

93. See *Myzel*, 386 F.2d at 738; *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 123 (W.D. Ark. 1949); *Geismar v. Bond & Goodwin*, 40 F. Supp. 876, 878 (S.D.N.Y. 1941). The definition of "control" promulgated by the SEC for purposes of reports filed pursuant to §§ 12, 13 or 15(d) required to be filed under the 1934 Act have served as a guidance for a number of courts: "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities by contract, or otherwise." 17 C.F.R. § 240.12b-2(f) (1985).

94. See, e.g., *Christoffel*, 588 F.2d at 688 (refusing to extend "controlling person" status on mere trustee because he was subject to a court's control and the discharge of his duties); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1135 (9th Cir. 1975) (holding a publisher's liability under § 20(a) cannot be judged by the standards applied to a broker-dealer). The district court in *Metge* noted that no previous case had attempted to impose controlling status on a lender. *Metge*, 577 F. Supp. at 817. The court stated: "Several cases and commentators have recognized the possibility that a lender could become a 'controlling person' with respect to a borrower." *Id.* (quoting *In re Falstaff Brewing Corp. Antitrust Litigation*, 441 F. Supp. 62, 68 (E.D. Mo. 1977)). Section 20(a) "was probably intended to apply to relationships like that of a broker and a brokerage company or a corporation and its controlling shareholder. However, by its terms it may apply to an entity, such as a lender, that assumes a controlling status." *Id.* See also *Lehr, Some Securities Law Issues in Lending on Pledged Stock*, 38 BUS. LAW 91, 100 (1982); *Sommer, Who's "in Control"?*—*S.E.C.*, 21 BUS. LAW 559, 564, 566, 571 (1966). Furthermore, the district court in *Metge* stated: "However, the Court is aware of no case in which such liability has actually been imposed on a lender." *Metge*, 577 F. Supp. at 817; see, e.g., *Fuls v. Shastina Props., Inc.*, 448 F. Supp. 983, 989-90 (N.D. Cal. 1978) (district court granting lender's motion for summary judgment on controlling count); *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp. 690, 707 (M.D. Fla. 1974) (memorandum opinion following trial, finding lender not liable as controlling person). Courts also have held that a national securities exchange cannot be liable as a "controlling person". See, e.g., *Carr v. New York Stock Exch., Inc.*, 414 F. Supp. 1292, 1303 (N.D. Cal. 1976); *Baty v. Pressman, Frohlich & Frost, Inc.*, 471 F. Supp. 390, 391 (S.D.N.Y. 1979).

95. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), *overruled on other grounds*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976).

of actual direction to hold a 'controlling person' liable."<sup>96</sup> In *Myzel* the Eighth Circuit utilized common law principles of agency to uphold a jury verdict against officers, directors, and majority stockholders of Lakeside Plastics & Engraving Company ("LPE").<sup>97</sup> The plaintiffs alleged that close business associates of the defendants misrepresented material facts in connection with the corporate repurchase of their stock.<sup>98</sup> Evidence was produced which proved that the business associates bought the plaintiff's shares when the price was depressed and then sold them directly to the corporation under a scheme to defraud them.<sup>99</sup>

Consequently, traditional common law doctrines of agency and *respondeat superior* satisfy the liberal construction of section 20(a) only where there exists requisite proof of influence or control.<sup>100</sup> Two distinct theories of control have been offered by the courts: control by status and control in fact.<sup>101</sup>

In the first line of cases, the courts focus on the defendant's status as a director or officer to impute controlling person liability under section 20(a).<sup>102</sup> The legal relationship of the allegedly controlling person to the institution through which the primary violator operated has been the center of the court's consideration.<sup>103</sup> Courts

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96. *Id.* at 738.

97. *Id.*

98. *Id.* at 733.

99. *Id.*

100. *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970) (citing RESTATEMENT (SECOND) OF AGENCY 257, 258 (1958)) (court held brokerage firm liable under the common law principles of agency); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir. 1970) (holding that § 20(a) does not preempt the doctrine of *respondeat superior* in the securities field).

101. 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, 1021-22 (1973) (where the terms "control by status" and "control in fact" were first introduced) [hereinafter cited as Note, *Burden of Control*]. See also Note, *Liability of Controlling Persons—Common Law and Statutory Theories of Secondary Liability*, 24 DRAKE L. REV. 621, 630-33 (1975).

102. See, e.g., *Rochez Bros.*, 527 F.2d at 890-91 (noting that one of the factors of control is the defendant's status); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812-13 (2d Cir. 1975) (SEC entitled to injunction primarily because defendant held a prominent position within the issuing company and was able to submit fraudulent quotations); *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1243-44 (S.D.N.Y. 1981) (holding that plaintiff need only allege control by status in order to state a claim under § 20(a)); *Harriman v. E.I. DuPont DeNemours & Co.*, 372 F. Supp. 101, 105 (D. Del. 1974) (where defendants possessed indirect means of influence with respect to affairs of securities company); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 915 (D. Me. 1971) (holding that director is *prima facie* a controlling person within the meaning of § 15 of the Act); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969) (stating that "[t]he conclusion is inescapable that persons who act as directors are in control of a corporation"), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

103. See, e.g., *Rochez Bros.*, 527 F.2d at 891. The defendant was clearly the "controlling person" as he was chairman of the board, chief executive officer, and president of

have concluded that because section 20(a) is remedial legislation, it should be construed liberally to further that underlying policy; therefore, plaintiffs do not have to show that the defendant was actually in a position to influence the primary violation since a corporate director or officer is presumed to have indirect control over the principal violator under normal agency principles.<sup>104</sup> The classic statement of this view came in *Moerman v. Zipco, Inc.*<sup>105</sup> The district court held that the directors indirectly controlled the president and were liable for his actions under section 20(a) for violations of the securities laws unless they sustained their burden of proving that they had acted in good faith.<sup>106</sup> The court reasoned that since a corporation must be deemed in control of its president, and all of the directors must be deemed in control of the corporation, the directors must be deemed to indirectly control the president.<sup>107</sup> Only a liberal construction of "indirect means of discipline or influence of actual direction" from *Myzel* could possibly support the district court's interpretation.<sup>108</sup>

Control by status essentially imposes a strict liability theory in securities law.<sup>109</sup> Reference to "legally enforceable control" found in the legislative history to section 20(a) arguably could support imposition of a strict liability theory under control by status cases.<sup>110</sup> However, a closer reading of that legislative history indicates that the actual control standard more accurately reflects congressional intent.<sup>111</sup> Furthermore, common sense dictates that a minority director

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the corporate defendant MS&R and owned 50% of the issued and outstanding stock. *Id.* Furthermore, the defendant "ran the day-to-day business activities of MS&R and obviously had the power to influence the policies and actions of MS&R." *Id.* See also *Dyer*, 336 F. Supp. at 915; *Moerman*, 302 F. Supp. at 447.

104. See *Johns Hopkins*, 422 F.2d at 1130; *Moerman*, 302 F. Supp. at 447. See also *Note, Burden of Control*, *supra* note 101, at 1021-22.

105. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd per curiam*, 422 F.2d 871 (2d Cir. 1970).

106. *Id.* at 447.

107. See *id.*

108. See note 103 and accompanying text *supra*.

109. See *Note, supra* note 101, at 631. The author commented: "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." *Id.*

110. See H.R. REP. NO. 1383, *supra* note 57, at 26 (citing *Handy & Harman v. Burnet*, 284 U.S. 136 (1931)). See also note 89 *supra*. In *Handy & Harman*, the issue was whether six majority shareholders collectively holding 75% of the stock of a corporation "controlled" the 20% of the stock owned by the president of that corporation, within the meaning of § 240(b)(2) of the Revenue Act of 1918. *Handy & Harman*, 284 U.S. at 138-41. Even though the president had pledged his shares to one of the majority stockholders as security for a loan and had never opposed the majority shareholders, the Court held that the majority shareholder did not have "legally enforceable control" of the president's stock as required under the Revenue Act. *Id.* at 140. However, the majority shareholders did exert actual control over the president. *Id.*

111. See H.R. REP. NO. 1383, *supra* note 57, at 26 (citing *Handy & Harman*, 284 U.S. at 140). The Court looked not at "legally enforceable control" alone. Rather, a

or officer who has unsuccessfully contested management policies, in the past and currently in the present, could not possibly be in control "in any meaningful sense."<sup>112</sup>

In the second line of cases the courts focus on the defendant's actual exercise of control, or control in fact, over the activities constituting the securities law violation.<sup>113</sup> Historically, the courts have approached the actual exercise of control issue as "a complex question of fact" requiring a close examination of the particular situation and organization.<sup>114</sup> In *Klapmeier v. Telecheck International, Inc.*<sup>115</sup> the district court offered the following statement:

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 of which cannot be limited to a cursory

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reading of the opinion reveals that the Court was looking for evidence of actual control:

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

*Handy & Harman*, 284 U.S. at 140.

112. Note, *supra* note 101, at 1023.

113. See, e.g., *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977). The *Christoffel* court stated: "Congress . . . intended a more restrictive meaning than that embraced by agency principles by also requiring some kind of participation by the controlling person in the activities of the controlled person which are claimed to be violative of the securities laws." *Christoffel*, 588 F.2d at 668. The *Stern* court's test required the plaintiff to establish "that those persons whom he contends are controlling persons have actively participated in the operations of [the primary violator] and possessed actual control over the transaction in question." *Stern*, 429 F. Supp. at 824. See also *Holloway v. Howerdd*, 377 F. Supp. 754, 761 (M.D. Tenn. 1973) (requiring some proof of actual participation in the controlled person's operation "before the consequences of control may be imposed"). See generally *Mader v. Armel*, 461 F.2d 1123, 1125 (6th Cir.) (finding that defendant neither knew nor should have known that any fraudulent activity was occurring), *aff'd*, 409 U.S. 1023 (1972).

114. See *Rochez Bros.*, 527 F.2d at 890. The Third Circuit in *Rochez Bros.* noted that "[m]any factors are involved in determining if one is a 'controlling person.'" *Id.* See also *Stern*, 429 F. Supp. at 824. To establish a prima facie case of controlling person liability, the plaintiff must demonstrate that the purported controlling persons "actively participated in the operations of [the primary violator]." *Id.* See also *Richardson v. MacArthur*, 451 F.2d 35, 41-42 (10th Cir. 1971) (defendant found to be controlling person within the meaning of § 20(a) of the Act because they were, in fact, in control of the general activity of their employee MacArthur); *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 123 (W.D. Ark. 1949) (defendant found to be controlling person for correspondent broker because the facts demonstrated that control existed).

115. 315 F. Supp. 1360 (D. Minn. 1970), *rev'd and remanded on other grounds*, 482 F.2d 247 (8th Cir. 1973).

review of their proportionate equity positions, employment or director status on the relevant dates.<sup>116</sup>

Precisely because the control in fact approach requires a factual analysis on a case-by-case basis, little consistency has evolved in the circuits to serve as guideposts along this treacherous path.<sup>117</sup>

It was recognized as early as 1912 that practical control of a corporation does not require ownership of fifty-one percent of its voting securities.<sup>118</sup> In 1912, the Supreme Court said in the Government's anti-trust suit against the Union Pacific Railroad: "It may be true that in small corporations the holding of less than a majority of the stock would not amount to control, but the testimony in this case is ample to show that, distributed as the stock is among many stockholders, a compact, united ownership of 46% is ample to control the operations of the [Southern Pacific Railroad Company]."<sup>119</sup>

Consistent with this concept, Congress took a broad view of control in the basic securities statutes.<sup>120</sup> Referring to the definition of "underwriter" in the 1933 Securities Act, the House Committee on Interstate and Foreign Commerce stated: "The concept of control herein involved is not a narrow one, depending upon a mathematical formula of 51 percent of voting power, but is broadly defined to permit the provisions of the act to become effective whenever the fact of control actually exists."<sup>121</sup> Later, in the discussion of the civil liability provisions of the Securities Exchange Act of 1934, under section

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116. *Id.* at 1361. However, the *Klapmeier* court went on to state that absence of substantial ownership does not foreclose liability under the 1933 Act as a "controlling person." *Id.* In the event that the evidence failed to establish the requisite quantum of actual control over the alleged violation, the next issue became whether the particular defendant was constructively a controlling person. *See id.* This approach lies between the two predominant lines of authority considering the definition of controlling persons, with control by status on one side and control in fact on the other. *See Note, supra* note 101, at 632. However, the *Klapmeier* approach has not attracted serious consideration.

117. *See, e.g., Rochez Bros.*, 527 F.2d at 890. Since Congress did not define "control," the implication is that "courts [should] construe the applicable provisions of the statute along with evidence adduced at trial." *Id.* *See also Lanza v. Drexel*, 479 F.2d 1277, 1298 (2d Cir. 1973); *Mader*, 461 F.2d at 1125-26; *Richardson*, 451 F.2d at 42.

118. L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 445 (1983).

119. *United States v. Union Pac. R.R.*, 226 U.S. 61, 95-96 (1912). The Court, in *Natural Gas Pipeline Co. v. Slattery*, 302 U.S. 300 (1937), stated: "We are not unaware that, . . . there are other methods of control of a corporation than through such ownership. Common management of corporations through officers or directors, or common ownership of a substantial amount, . . . gives such indication of unified control as to call for close scrutiny of a contract between them whenever the reasonableness of its terms is the subject of inquiry." *Id.* at 307-08. In *Denver & Rio Grande Western R.R. v. United States*, 387 U.S. 485 (1967), the Court held that the acquisition of 20% of the stock of Railway Express Agency by the Greyhound Corporation might constitute control. *Id.* at 489, 522.

120. *See H.R. REP. NO. 85*, 73d Cong., 1st Sess. 14 (1933).

121. *See id.*

20(a), the House committee utilized the same broad construction of the concept of control.<sup>122</sup>

Keeping the same view of control held by the courts and by Congress, the Securities Exchange Commission ("SEC") has promulgated its own definition of control.<sup>123</sup> Even though the definitions were created to clarify registration requirements, their reference can be seen in many key cases discussing controlling person liability.<sup>124</sup> The rules define "control" (including the terms "controlling," "controlled by," and "under common control with") to mean "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."<sup>125</sup>

In other important securities regulations acts, Congress has defined and then limited the concept of control in an inconsistent manner. For example, the Public Utilities Holding Company Act of 1935 does not define "control" *per se*, but it does define "holding company," "subsidiary company," and "affiliate" which determines the status of persons under the Act generally.<sup>126</sup> Under this Act, a "holding company" and a "subsidiary company" are based upon ten percent ownership.<sup>127</sup> Essentially, a ten percent stockholder is presumed to be a holding company unless it proves otherwise.<sup>128</sup> Any company not holding ten percent is presumed not to be a holding company unless the SEC establishes otherwise.<sup>129</sup> Regardless of the ten percent figure, the SEC can declare anyone to be a holding company where the SEC determines that the person exercises a controlling influence along or with others.<sup>130</sup> Compare this definition with the term "affiliate," which utilizes a five percent test to further drive the point home that control can exist with varying degrees of ownership.<sup>131</sup> Under the Investment Company Act of 1940,<sup>132</sup> the concept of "control" utilizes a twenty-five percent test:

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122. See note 89 *supra*.

123. See Trust Indenture Act of 1939, Rule 0-2 (codified at 17 C.F.R. § 260.0-2(f) (1985)); Securities Exchange Act of 1934, Rule 12b-2 (codified at 17 C.F.R. § 240.12b-2 (1985)); Securities Act of 1933, Rule 405 (codified at 17 C.F.R. § 230.405 (1985)); Regulation S-X, Rule 1-02 (codified at 17 C.F.R. § 210.1-02(g) (1985)).

124. See *Pharo v. Smith*, 621 F.2d 656, 670 (5th Cir. 1980) (specifically referring to Rule 405 of the 1933 Securities Act); *Rochez Bros.*, 527 F.2d at 890 (specifically referring to Rule 12(b)-2 of the 1934 Securities Exchange Act).

125. See 17 C.F.R. § 240.12(b)-2.

126. See Public Utility Holding Company Act of 1935 § 2(a)(7), (8), (11) (codified at 15 U.S.C. § 79b(a)(7), (8), (11) (1982)).

127. See *id.* § 2(a)(7)(A)-(8)(A) (codified at 15 U.S.C. § 79b(a)(7)(A)-(8)(A) (1982)).

128. *Id.*

129. *Id.*

130. *Id.*

131. See *id.* § 2(a)(11) (codified at 15 U.S.C. § 79b(a)(11) (1982)).

132. 15 U.S.C. §§ 80a-1 to -64 (1982).

"Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percentum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 percentum of the voting securities of any company shall be presumed not to control such company. . . .<sup>133</sup>

The Investment Company Act negates control where the exercise of the controlling influence "is solely the result of an official position with such company."<sup>134</sup> This would indicate that Congress expects from the courts more than "a cursory review of . . . proportionate equity positions, employment or director status on relevant dates."<sup>135</sup>

Finally, despite the phenomenon of "minority control,"<sup>136</sup> a control-by-status standard under section 20(a) could ensnare an extraordinary range of persons "with little or no voice in the operation of an institution."<sup>137</sup> The list of potential "deep pocket" defendants could include customers with a substantial interest in the corporation or creditors who possess a substantial block of pledged voting stock.<sup>138</sup> If nothing more than the defendant's status need be shown by the plaintiff, then the "dynamic balance between the policy of investor protection and legitimate competing interests of honest business" shifts intolerably toward investor protection.<sup>139</sup> Such a

133. See Investment Company Act of 1940 § 2(a)(9) (codified at 15 U.S.C. § 80a-2(a)(9) (1982)).

134. *Id. Cf. In re Transit Inv. Corp.*, 23 S.E.C. 415, 420 (1946) (holding that an individual was a controlling person when his status as president was the result, rather than the source, of his power). In *Transit Inv. Corp.*, even though the company president held less than three percent of the outstanding voting stock in his company, he still had the confidence of four family groups that together accounted for over 31%. *Id.* This particular case led Professor Louis Loss to warn: "Accordingly, although a person's being an officer or director does not create any presumption of control, it is sort of a red light." L. LOSS, *supra* note 118, at 455.

135. *Klapmeier*, 315 F. Supp. at 1361. See also notes 103-04 and accompanying text *supra*.

136. The well-known phenomenon of "minority control" arises where the concept of control is "divorced" from the incidents of ownership, as is usually found in large, public-issue corporations. See Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212, 1213 (1958); Note, *supra* note 101, at 1023 n.31. See also L. LOSS, *supra* note 118, at 453 n.31. Professor Loss stated: "Everything else being equal, the amount of stock required to give a particular person control decreases as the number of other holders increases and as the amount of stock usually represented at the annual meetings decreases." *Id.*

137. Note, *supra* note 101, at 1024.

138. *Id.*

139. See *id.* The author stated: "The Exchange Act represents a dynamic balance between the policy of investor protection and the legitimate competing interests of

consequence is manifestly unfair to the defendant, particularly since a section 20(a) plaintiff "need not proceed against the principal perpetrator, nor need the principal perpetrator be identified in the complaint."<sup>140</sup> The section 20(a) defendant may not know that legitimate business activities commensurate with their particular status or positions led to the guilty controlling person liability. Consequently, an element of uncertainty enters into what previously was a completely normal business transaction. As a result, the policy of investor protection outweighs legitimate business interests.

### *The Good Faith Defense and Vicarious Liability*

Once a section 20(a) plaintiff establishes that the defendant is a controlling person, the burden shifts to the defendant to establish a good faith defense or that he "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."<sup>141</sup> Similar to the concept of control, this language has met with varying interpretations. Generally, the good faith defense will shield a person from liability if he can show that he exercised reasonable internal supervision against the securities violation.<sup>142</sup>

Examples of the application of the special defenses are found in *Johns Hopkins University v. Hutton*<sup>143</sup> and *Kamen & Co. v. Paul H. Aschkar & Co.*<sup>144</sup> Both the *Johns Hopkins* and *Kamen* courts allude

'honest business.'" *Id.* See Letter from Franklin D. Roosevelt to Congress (Mar. 29, 1933), reprinted in 77 CONG. REC. 937 (1933). President Roosevelt expressed: "The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business." *Id.* See also Henkel, *Codification—Civil Liability Under the Federal Securities Law*, 22 BUS. LAW. 866, 867 (1967). The author warned that promotion of the policy of investor protection should not be pursued in such a way as to "encourage strike suits, frivolous claims, [or] class actions which are spurious." *Id.*

140. *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170 n.47 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). *Accord* *Newberg v. American Dryer Corp.*, 195 F. Supp. 345, 353-54 (E.D. Pa. 1961) (action brought under § 15). Cf. *Kemmerer v. Weaver*, 445 F.2d 76, 78 (7th Cir. 1971) (action brought under § 20(a)). See also Folk, *Civil Liabilities Under the Federal Securities Act: The BarChris Case*, 55 VA. L. REV. 199, 217-18 (1969). See generally Note, *supra* note 101, at 1024.

141. 15 U.S.C. § 77o (1982). Section 20(a) of the 1934 Exchange Act provides that a controlling person shall be liable, "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.* § 78t(a).

142. See, e.g., *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir.), cert. denied, 423 U.S. 1025 (1975) (publisher held as a controlling person not vicariously liable under the doctrine of *respondet superior* for reporter's misstatements); *Savoy Indus.*, 587 F.2d at 1170 (rejecting district court's finding that defendant failed to establish a good faith defense).

143. 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part, and remanded*, 422 F.2d 1124 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974).

144. 382 F.2d 689 (9th Cir. 1967), cert. dismissed, 393 U.S. 801 (1968).

to agency principles as one possible alternative to strict application of the controlling person sections.<sup>145</sup> However, the courts reached opposite conclusions as to the extent to which the controlling person provisions replace or supplement common law.<sup>146</sup>

In *Johns Hopkins*, the Trice Production company employed a stock brokerage firm, W.E. Hutton, to act as its agent in the sale of production payments carved out of oil and gas properties belonging to Trice.<sup>147</sup> During the course of the sale to Johns Hopkins University, Hutton's oil and gas manager, LaPiere, made certain misrepresentations and omissions.<sup>148</sup> Eventually, Johns Hopkins sued W.E. Hutton for rescission of the transaction.<sup>149</sup> The district court noted that the controlling person sections supplement common law principles of agency and *respondeat superior*.<sup>150</sup> The court indicated that the defenses of good faith and lack of participation do not apply since "such a result would leave investors with much shallower protection than was intended by Congress in its passage of the '33 Act and the 1934 amendment to Section 15."<sup>151</sup> The Fourth Circuit Court of Appeals sustained the finding of liability against Hutton, relying upon agency principles.<sup>152</sup> The court stated that Hutton had given LaPiere, Hutton's agent, actual and apparent authority to provide plaintiff with information needed for the sale.<sup>153</sup> Furthermore, the Fourth Circuit held that LaPiere had acted within the scope of his employment by offering the production payments to Johns Hopkins.<sup>154</sup> Finally, the Fourth Circuit held that "Hutton is liable, under familiar principles, for the tortious representations of the agent."<sup>155</sup>

In *Kamen*, a brokerage firm gave two employees the responsibil-

145. See *Kamen*, 382 F.2d at 694; *Johns Hopkins*, 297 F. Supp. at 1211-12.

146. Compare *Kamen*, 382 F.2d at 697 (holding that controlling person sections were exclusive method of imposing secondary liability rather than common law principles of agency and *respondeat superior*) with *Johns Hopkins*, 297 F. Supp. at 1212 (holding that controlling person liability supplements common law principles of agency and *respondeat superior*).

147. *John Hopkins*, 297 F. Supp. at 1173.

148. *Id.* at 1217.

149. *Id.* at 1172.

150. *Id.* at 1211-12.

151. *Id.* at 1213.

152. *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970).

153. *Id.*

154. *Id.*

155. *Id.* (citing RESTATEMENT (SECOND) OF AGENCY §§ 257-58 (1958)). Section 257 of the *Restatement (Second) of Agency* 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:

- (a) authorized;
- (b) apparently authorized; or
- (c) within the power of the agent to make for the principal.

ity of obtaining the listed business of over-the-counter, non-member, broker dealers.<sup>156</sup> The two men engaged in illegal activities by making repurchase guarantees to various broker dealers.<sup>157</sup> Utilizing the same principles of agency employed in *Johns Hopkins*, the court held that the plaintiff did not act "as a reasonably prudent person in concluding, and asserting his belief, that the purported agents were possessed with the ostensible authority to offer to him the transactions and promises which they did."<sup>158</sup> The Ninth Circuit held that the plaintiff should have inquired further regarding the agents' authority because the guaranteed profit plan they offered was plainly unusual.<sup>159</sup> *Kamen* is important primarily because of the concept of exclusivity which had arisen from interpretations of that opinion.<sup>160</sup> Essentially, the *Kamen* rule holds that secondary liability is measured by applying the "controlling person" and good faith standards of section 20(a) and not the doctrine of *respondeat superior*.<sup>161</sup>

Plaintiffs have sued defendants under section 10(b) using the theory of *respondeat superior* to successfully prevent employers from relying upon this good faith defense.<sup>162</sup> Under the common law doctrine of *respondeat superior*, employers are strictly liable for the improper acts of their agents committed within the scope of the agents'

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156. *Kamen*, 382 F.2d at 691.

157. *Id.* at 691-92.

158. *Id.* at 696.

159. *Id.*

160. See *Zweig*, 521 F.2d at 1132. The exclusivity concept centers on the issue of whether § 20(a) forecloses holding a principal who "controls" an agent or employee vicariously liable. See Note, *supra* note 112, at 128, 131-32. The circuits are split on the proper resolution of this issue. Compare *Rochez Bros.*, 527 F.2d at 889 (holding that common law principles do not apply toward controlling person liability) with *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-52 (7th Cir. 1974) (stating that § 20(a) extends common law principles of vicarious liability and *respondeat superior*), *Zweig*, 521 F.2d at 1132 (holding that § 20(a) is exclusive method for imposing controlling person liability), *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974) (stating that congressional intent regarding § 20(a) was to impose liability only on those directors who fall within its definition of control), *Johns Hopkins*, 422 F.2d at 1130 (sustaining liability against defendant relying upon common law agency principles), *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir. 1970) (refusing to apply common law doctrine of *respondeat superior* against defendants under § 15 of the 1933 Act).

161. See *Zweig*, 521 F.2d at 1132-33. The Ninth Circuit recently reaffirmed the "Kamen Rule." *Christoffel*, 588 F.2d at 667. *Accord Rochez Bros.*, 527 F.2d at 885 n.9 (recognizing existence and reaffirmance of the "Kamen Rule").

162. See *In re Atlantic Fin. Management, Inc. Sec. Litigation*, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 92,482 (1st Cir. Feb. 19, 1986); *Henricksen v. Henricksen*, 640 F.2d 880, 887 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1980); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 712 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); *Holloway*, 536 F.2d at 694-95; *Carras v. Burns*, 516 F.2d 251, 260-61 (4th Cir. 1975); *Bird v. Ferry*, 497 F.2d 112, 116-17 (5th Cir. 1974) (Coleman, C.J., dissenting); *Fey*, 493 F.2d at 1051-52 (7th Cir. 1974); *Richardson v. MacArthur*, 451 F.2d 35, 41-42 (10th Cir. 1971).

employment.<sup>163</sup> A majority of circuits have taken the position that the controlling person provisions were not intended to preempt the doctrines of *respondeat superior* or otherwise to constitute the exclusive means for imposing secondary liability under the federal securities laws.<sup>164</sup> Generally, these circuits interpret the controlling person provisions to expand, rather than to restrict, the scope of liability under the securities laws.<sup>165</sup> *Marbury Management Inc. v. Kohn*,<sup>166</sup> illustrates this view.

In *Marbury*, a brokerage firm's employee committed securities fraud on the plaintiffs Marbury Management and Harry Bader.<sup>167</sup> The plaintiffs sued the brokerage firm and the employee under sections 10(b) and 20(a) of the 1934 Act.<sup>168</sup> After reviewing the various circuits' positions, the court held that the brokerage firm could be liable under both the controlling person provision of section 20(a) and *respondeat superior*.<sup>169</sup> The court rejected the exclusivity argument followed by the Third and Ninth Circuits, reasoning that "there is no warrant for believing that Section 20(a) was intended to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles."<sup>170</sup> To reach this conclusion, the Second Circuit relied on the principles of agency espoused in the *Restatement (Second) of Agency*.<sup>171</sup> The *Marbury* court held that the good faith defense in the last clause of section 20(a) was unavailable where *respondeat superior* principles are applied.<sup>172</sup>

To avoid strict liability under the doctrine of *respondeat supe-*

163. See *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 741 (10th Cir. 1974); RESTATEMENT (SECOND) OF AGENCY 257 (1958). See also note 155 and accompanying text *supra*. See generally Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1016-17 (1983). The authors commented:

The principal justification is that the employer controls the acts of his employee. The employer hires the employee, expects to profit from his conduct, and so should bear the burden if his conduct is wrongful. Additionally, the employer places in the employee's hands the means to commit the wrong and the employer should be given the incentive to conduct his business safely. A modern justification frequently given is that the doctrine represents a policy determination to allocate the risk of loss to the employer, rather than to the innocent victims of the employee's misconduct, since the employer can absorb the monetary loss as a cost of doing business.

*Id.* (citations omitted).

164. See note 162 and accompanying text *supra*.

165. See note 162 and accompanying text *supra*.

166. 629 F.2d 705 (2d Cir. 1980), *cert denied*, 449 U.S. 1011 (1981).

167. *Id.* at 707.

168. *Id.* at 707, 712.

169. *Id.* at 716.

170. *Id.*

171. See *id.*

172. *Id.*

rior, employer defendants have argued that the controlling person sections, with their good faith defense, are the exclusive method of imposing liability on employers under the securities acts.<sup>173</sup> In *Zweig v. Hearst Corp.*,<sup>174</sup> the Ninth Circuit relied on its previous decision in *Kamen* to rule that section 20(a) supplants vicarious liability of an employer under the doctrine of *respondeat superior*.<sup>175</sup>

The Third Circuit in *Rochez Brothers, Inc. v. Rhoades*<sup>176</sup> reviewed the legislative history of the controlling person provisions and concluded that the use of *respondeat superior* to impute secondary liability on employers would not advance the legislative purpose of the 1934 Act.<sup>177</sup> Furthermore, the court recognized that corporations have duties imposed on them for the protection of the public interest.<sup>178</sup> However, imposing strict liability on the employers and directors would violate section 20(a)'s legislative purpose, effectively emasculating it.<sup>179</sup> Therefore, the court ruled that *respondeat superior* is not applicable to determine secondary liability in a securities violation case.<sup>180</sup> However, the court would not impose the same rule in broker-dealer cases "where a stringent duty to supervise employees does exist."<sup>181</sup> This duty, the court noted, is imposed to protect the investing public and to make brokers aware of the special responsibility that they owe to their customers.<sup>182</sup>

The broker-dealer exception in *Rochez Brothers* was applied to accountants in *Sharp v. Coopers & Lybrand*.<sup>183</sup> The Third Circuit reaffirmed its position that *respondeat superior* was not applicable in most securities law cases.<sup>184</sup> However, the court held that the accounting firm of Coopers & Lybrand was liable under the doctrine of *respondeat superior* for misleading opinion letters issued under the firm's securities sales program.<sup>185</sup> The court looked for support to the Second Circuit and its opinion in *Marbury Management*, noting that previous Second Circuit opinions declined to apply *respondeat*

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173. See *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 393-94 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *Christoffel*, 588 F.2d at 668-69; *Rochez Bros.*, 527 F.2d at 889; *Zweig*, 521 F.2d at 1135; *Klapmeier*, 482 F.2d at 256; *Kamen*, 382 F.2d at 696.

174. 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

175. *Id.* at 1132.

176. 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976).

177. *Id.* at 885.

178. *Id.*

179. *Id.* at 885-86.

180. *Id.* at 886.

181. *Id.* (citing *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *SEC v. First Sec. Co.*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972)).

182. *Rochez Bros.*, 527 F.2d at 886.

183. 649 F.2d 175, 182-83 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

184. *Id.* at 181.

185. *Id.* at 184-85.

*superior* in other contexts.<sup>186</sup> The Second Circuit only applied the doctrine to brokerage firms.<sup>187</sup> With a view toward the facts of the *Sharp* case, the Third Circuit held that Coopers & Lybrand placed itself in a position of trust and confidence for the investing public. Therefore, the principles of *respondeat superior* should apply.<sup>188</sup>

#### *Good Faith Defense and Culpable Participation*

Generally, a review of the circuit courts of appeals discloses that the nature of the defendant controlling person's work will decide whether vicarious liability applies or whether section 20(a) is the exclusive method of imposing liability under the securities acts.<sup>189</sup> The defendant's status is important in another way. A significant number of the courts have held that a controlling person's failure to take adequate measures to prevent injury to the public, caused by an agent or employee, may destroy the controlling person's defense of good faith.<sup>190</sup> Most of these cases have involved brokerage firms,<sup>191</sup> nevertheless, the Third Circuit's opinion in *Sharp* could apply to almost anyone in a position of trust and confidence for the investing public.<sup>192</sup> Some courts require a lesser standard of good faith where the controlling person was not a brokerage firm.<sup>193</sup> In *G.A. Thompson & Co. v. Partridge*,<sup>194</sup> the plaintiffs, who were buyers of securities, brought suit against former shareholders, directors, and officers of Lincoln Home Mortgage Company, alleging violations of state and federal securities laws.<sup>195</sup> After deciding that one of the defendants was a controlling person, the next issue became whether he possessed a good faith defense;<sup>196</sup> namely, whether he "failed to establish, maintain or diligently enforce a proper system of supervision and control."<sup>197</sup> The court noted, "The test of whether the control-

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186. *Id.* at 184.

187. *Id.* at 185.

188. *Id.* at 183.

189. See *Henricksen*, 640 F.2d at 884-85; *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981); *Paul F. Newton & Co.*, 630 F.2d at 1120; *Zweig*, 521 F.2d at 1129; *Richardson*, 451 F.2d at 41-42; *Moerman*, 302 F. Supp. at 447; *Hect v. Harris, Upham & Co.*, 282 F. Supp. 417, 438-39 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Lorenz v. Watson*, 258 F. Supp. 724, 733 (E.D. Pa. 1966). See generally *Ferrara & Sanger*, *supra* note 163, at 1013-14.

190. See cases cited note 189 *supra*.

191. See *Marbury Management*, 629 F.2d at 712-16 (citations omitted).

192. See *Sharp*, 649 F.2d at 183.

193. See, e.g., *Savoy Indus.*, 587 F.2d at 1170 (recognizing that a good faith defense exists in § 20(a)); *Zweig*, 521 F.2d at 1134-35 (holding that defendant-publisher's vicarious liability under § 20(a) not judged by the standards applied to a broker-dealer).

194. 636 F.2d 945 (5th Cir. 1981).

195. *Id.* at 950-51.

196. *Id.* at 957.

197. *Id.* at 958 (citing *Paul F. Newton & Co.*, 630 F.2d at 1120) (relying on previous

ling person has done enough to prevent the violation depends on what he could have done under the circumstances."<sup>198</sup> The Fifth Circuit adopted a recklessness standard for the controlling person's failure to supervise or control, reasoning that if intent were required there would be little purpose for enacting the controlling person provisions; "the provision would hardly make anyone liable who would not be so otherwise."<sup>199</sup>

Other courts have rejected the position that the failure to supervise adequately vitiates the good faith defense.<sup>200</sup> The Second and Third Circuits have ruled that Congress intended liability to be based on something more than control and failure to adequately supervise.<sup>201</sup> Both circuits will impose liability on those who were controlling persons and who were "in some meaningful sense culpable participants in the fraud perpetrated by controlled persons."<sup>202</sup>

In *Rochez Brothers*, the Third Circuit noted that the Senate and the House advanced their own versions of the standard that should govern controlling persons.<sup>203</sup> The Senate bill proposed an "insurer's liability" standard because it "would have rendered an issuer, its directors, chief executive officer and financial officers strictly liable for the return of any compensation paid for shares sold by means of a materially false or misleading registration statement."<sup>204</sup> The House opted for a "fiduciary standard" which "generally provides a due care defense to corporate directors, and to the rest of the broader class of professionals subjected to liability under that section."<sup>205</sup> The Third

cases addressing the good faith defense in the circuit). See *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 194-95 (5th Cir. 1979) (citing *Delporte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1154 (5th Cir. 1977)), modified on reh'g, 611 F.2d 105 (5th Cir. 1980).

198. *G.A. Thompson & Co.*, 636 F.2d at 959.

199. *Id.* at 959-60.

200. See *Sharp*, 649 F.2d at 189 (citing *Rochez Bros.*, 527 F.2d at 889). The court held that the purpose of § 20(a) is to impose secondary liability on one who controls a violator of the securities laws and who fails to show he acted "in good faith." *Id.* See also *Gordon*, 506 F.2d at 1085 (quoting *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973)). The court noted that congressional intent was to impose controlling person liability on those who were "in some meaningful sense culpable participants in the fraud perpetrated by controlled persons". *Id.*

201. See note 200 *supra*.

202. See *Ferrara & Sanger*, *supra* note 163, at 1014 (quoting *Lanza*, 479 F.2d at 1299).

203. *Rochez Bros.*, 527 F.2d at 285.

204. *Ferrara & Sanger*, *supra* note 163, at 1013 n.38 (citing *Christoffel*, 588 F.2d at 668). See generally S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933) (noting that directors who execute registration statements are liable for the consequences of untrue statements; loss is not thrown on the buyer).

205. *Ferrara & Sanger*, *supra* note 163, at 1013 n.38 (citing H. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933)) (noting that the fiduciary standard applies broadly to all parties who prepare and sign the registration statement — underwriters, directors of the

Circuit reasoned that because the House version was adopted, Congress did not intend anyone to be an insurer against the fraudulent activities of another.<sup>206</sup> The court continued: "What Congress did intend was to impose liability on those who were controlling persons and who were 'in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.'"<sup>207</sup>

When the controlling person liability is predicated on silence or inaction, the *Rochez Brothers* court's decision indicates that the plaintiff must prove that the defendant's inaction or silence was deliberate and done intentionally to further the fraudulent activity.<sup>208</sup> Few cases have addressed the question of silence or inaction under the controlling person provisions. However, cases decided by the Fourth and Ninth Circuits indicate that some kind of culpability must be shown.<sup>209</sup> For example, in *Christoffel v. E.F. Hutton & Co.*,<sup>210</sup> the Ninth Circuit adopted the *Rochez Brothers* court's rationale and ruled that a brokerage firm, which did not in any way participate in the activities of one of its account executives, was not liable as a "controlling person."<sup>211</sup> The Ninth Circuit did not address the issue of the brokerage firm's good faith defense; however, it refused to extend vicarious liability where the secondary defendant's activity is mere inaction.<sup>212</sup>

## AIDING AND ABETTING

### *Historical Roots*

The Securities Act of 1933<sup>213</sup> and the Securities Exchange Act of 1934<sup>214</sup> created several express private rights of action.<sup>215</sup> In addition to the private actions created explicitly by the 1933 Act and 1934 Act, the federal courts have implied private remedies under other provi-

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issuer, accountants, engineers, appraisers — unless they prove good faith and lack of knowledge). See also notes 340-46 and accompanying text *infra*.

206. *Rochez Bros.*, 527 F.2d at 885.

207. *Id.* (quoting *Lanza*, 479 F.2d at 1299).

208. *Id.* at 890.

209. See *Carpenter*, 594 F.2d at 394 (citing *Lanza*, 479 F.2d at 1299); *Christoffel*, 588 F.2d at 669; *Mecht*, 430 F.2d at 1210 (citing *Kamen*, 382 F.2d at 697).

210. 588 F.2d 665 (9th Cir. 1978).

211. *Id.* at 669 (citing *Rochez Bros.*, 527 F.2d at 889).

212. *Id.*

213. 15 U.S.C. §§ 77a-77b (1982).

214. 15 U.S.C. §§ 78a-78h (1982).

215. See Securities Act of 1933, §§ 11, 12, 15 (codified at 15 U.S.C. §§ 77k, 77l, 77o (1982)) (imposing civil liability for filing false registration statements, false prospectuses, and controlling person activity, respectively). See also Securities Exchange Act of 1934, §§ 9, 16, 18 (codified at 15 U.S.C. §§ 78i, 78p(b), 78r (1982)) (imposing civil liability for manipulating security prices, unfair use of "inside" information, and misleading statements, respectively).

sions of the two securities acts.<sup>216</sup> Civil liability under section 10(b) of the 1934 Act<sup>217</sup> and Rule 10b-5<sup>218</sup> has been "consistently recognized" for forty years.<sup>219</sup> The federal judiciary borrowed heavily from criminal and tort theories to fashion the elements of civil liability, especially in recognizing aiding and abetting liability.<sup>220</sup>

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216. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-31 (1964) (recognizing that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Securities Exchange Act of 1934); *Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216, 1222 (4th Cir. 1980) (finding an implied private right to bring suit in § 13(d) of the Securities Exchange Act of 1934), *cert. denied*, 449 U.S. 1101 (1981). Compare *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978) (imposing an implied cause of action under § 17(a) of the Securities Act of 1933), *cert. denied*, 442 U.S. 909 (1979) with *Herman & MacLean*, 459 U.S. at 379 n.2 (1983) (reserving decision on whether § 17(a) of the Securities Act of 1933 affords a private remedy) and *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979) (reserving judgment on the issue of a private right of action under § 17(a) of the Securities Act of 1933). But cf. *Touche Ross & Co. v. Redington*, 422 U.S. 560, 574 (1979) (denying plaintiffs an implied cause of action for damages under § 17(a) of the Securities Exchange Act of 1934).

217. 15 U.S.C. § 78j(b) (1982). This section provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

218. 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The story of Rule 10b-5's origin is recalled by its author Milton Freeman, SEC staff attorney at that time, in *Conference on Codification of the Federal Securities Law*, 22 BUS. LAW. 793, 921-23 (1967).

219. See *Herman & MacLean*, 459 U.S. at 380. A right of action under Rule 10b-5 was first recognized by the *Kardon* court. *Kardon*, 69 F. Supp. at 513. The Supreme Court confirmed the existence of an implied right of action under Rule 10b-5, without extended discussion, in *Superintendent v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). The Court has repeatedly reaffirmed that "the existence of a private cause of action for violations of the statute [§ 10(b)] and the Rule [Rule 10b-5] is now well established." *Ernst & Ernst*, 425 U.S. at 196. See also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972).

220. *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939) (first securities fraud case to recognize aiding and abetting liability), *rev'd in part on other grounds*, 142 F.2d 744 (9th Cir. 1944). Although the *Timetrust* case involved a SEC injunction against the defendants under § 17(a) of the Securities Act of 1933, codified at 15 U.S.C. § 77q(a) (1982), the court looked to aiding and abetting principles as found in criminal

In developing a theory of aiding and abetting liability under Rule 10b-5, the courts generally relied on section 876 of the *Restatement of Torts*,<sup>221</sup> which provides:

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

(a) orders or induces such conduct, knowing of the conditions under which the act is done of intending the consequences which ensue, or

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or

(c) gives substantial assistance to the other in accomplishing tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.<sup>222</sup>

In the "landmark" case of *Brennan v. Midwestern United Life Insurance Co.*,<sup>223</sup> the *Restatement of Torts* view first took seed. In that

law. *Timetrust*, 28 F. Supp. at 43, nn.44-45. The major source of criminal theory has been 18 U.S.C. § 2(a) (1969) which provides: "Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal." See *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 28 (S.D.N.Y. 1963); *In re Burley & Co.*, 23 S.E.C. 461, 466, 468 n.11 (1942). The Supreme Court, in *Nye & Nissen v. United States*, 336 U.S. 613 (1949), stated that "[i]n order to aid and abet another to commit a crime it is necessary that a defendant 'in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, [and] that he seek by his action to make it succeed.'" *Id.* at 619 (quoting *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938)). Subsequent cases have applied precedents from criminal law. See *Woodward*, 522 F.2d at 95 n.23 (comparing the Supreme Court's definition of aiding and abetting in the criminal area enunciated in *Nye & Nissen*). See also Ruder, *Multiple Defendants*, *supra* note 1, at 626-29 (illustrating application of criminal law concepts to secondary liability theories). Many courts have defined aiding and abetting by referring to § 876(b) of the *Restatement of Torts*, which imposes liability for harm to a third party if the person "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself." See also *Brennan*, 259 F. Supp. at 680. The court held: "Such principles as stated in the . . . cases, . . . and formulated in the *Restatement of Torts* surely best fulfill the purposes of the Securities Exchange Act of 1934 and are a logical and natural complement to the *Kardon* doctrine." *Id.* Cases have invoked the tort law principle as a source of liability for aiders and abettors. See, e.g., *Rochez Bros.*, 527 F.2d at 886 (quoting the RESTATEMENT OF TORTS § 876(b) (1939)); *In re Gap Stores Sec. Litig.*, 457 F. Supp. 1135, 1143 (N.D. Cal. 1978) (quoting the RESTATEMENT OF TORTS § 876 (1939)); *Fischer v. Kletz*, 266 F. Supp. 180, 197 (S.D.N.Y. 1967) (recognizing that the *Restatement of Torts* conveniently provides the necessary standard to measure a defendant's putative liability). See also Ruder, *Multiple Defendants*, *supra* note 1, at 620-25 (illustrating application of tort law concepts to aiding and abetting liability).

221. See note 220 *supra*.

222. RESTATEMENT OF TORTS § 876 (1939). Subsection (a) has been replaced with the following: "(a) does a tortious act in concert with the other or pursuant to a common design with him." RESTATEMENT (SECOND) OF TORTS § 876(a) (1979).

223. 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). See Ruder, *Multiple Defendants*, *supra* note 1, at 620 (referring to *Brennan*

case the plaintiffs brought a class action suit on behalf of all persons who had bought stock in Midwestern United Life Insurance Company ("Midwestern") from Michael Dobich and Dobich Securities Corporation, but failed to receive delivery of their stock.<sup>224</sup> The plaintiffs claimed that Midwestern should be liable because it knowingly assisted Dobich in the fraud.<sup>225</sup> The district court denied the defendants' motion to dismiss the claim for failure to state a cause of action, relying partly upon the tort theories stated in section 876 of the *Restatement of Torts*.<sup>226</sup>

The concepts introduced by tort law into aiding and abetting liability are as timely today as they were then. Under clause (1) of section 876, a person is secondarily liable for the harm to a third party where he induces or orders the tortious conduct of another, knowing the conditions under which the other acts or intending the consequences of the other's actions.<sup>227</sup> Subsection (a) parallels the agency principles found within the early decisions supporting liability in securities litigation.<sup>228</sup> Under clause (b), aiding and abetting liability

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as "the most important securities law case dealing with secondary liability"); Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damages Actions*, 62 TEX. L. REV. 1087, 1093 (1984) (referring to *Brennan* as a "landmark case"); Comment, *Rule 10b-5 Liability After Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218, 223 (1977) (referring to *Brennan* as "a landmark decision").

224. *Brennan*, 259 F. Supp. at 675.

225. *Id.*

226. *Id.* at 680. See Ruder, *Multiple Defendants*, *supra* note 1, at 621. When the district court reheard the case on the merits, it did not rely primarily on § 876 of the *Restatement of Torts*; however, it did state that the general concept of aiding and abetting "has been formulated in a most helpful manner in the *Restatement of Torts* § 876." *Brennan*, 286 F. Supp. at 708. Although aiding and abetting liability could be predicated on any one of the three clauses, the courts generally turn to subsection (b) as the basis of aider-abettor liability. See note 220 *supra*.

227. RESTATEMENT (SECOND) OF TORTS § 876(b) (1979). Section 876(a) was re-drafted when the *Restatement (Second) of Torts* was enacted. See note 222 *supra*. The comment to this section states: "When two or more persons commit tortious acts in concert, each becomes subject to liability for the acts of the others, as well as for his own acts." RESTATEMENT (SECOND) OF TORTS § 876 comment a, at 316 (1979). However, merely having a common plan, design or express agreement will not induce liability, as "there must be acts of a tortious character in carrying it into execution." *Id.* Furthermore, the conduct of the actor must be in and of itself tortious: "One who innocently, rightfully and carefully does an act that has the effect of furthering the tortious conduct or cooperating in the tortious design of another is not for that reason subject to liability." *Id.*

228. See, e.g., *Johns Hopkins*, 422 F.2d at 1130 (utilizing "familiar principles" to find defendant liable for tortious representations of its agents); *Kamen*, 382 F.2d at 695 (endorsing, in securities law fraud litigation, RESTATEMENT (SECOND) OF AGENCY § 166, comment a, § 258, comment b (1958)). See also Ruder, *Multiple Defendants*, *supra* note 1, at 603. Professor Ruder stated: "The use of agency principles to support liability in securities litigation suggests that the semi-codified principles of the common law as set forth in the *Restatement of Agency* and *Restatement of Torts* are becoming part of the securities law civil liability framework." *Id.*

arises where the primary party's act is known to be tortious *and* the aider-abettor's encouragement or assistance "is a substantial factor in causing the resulting tort."<sup>229</sup> Clause (b) clearly embodies the theory of aiding and abetting liability.<sup>230</sup> Pursuant to the *Restatement of Torts* comments, clause (c) imputes secondary liability where both a person breaches a duty to a third person *and* his conduct substantially assists another in accomplishing a tortious result.<sup>231</sup> It is not certain exactly what duty is owed by the secondary participant to the injured third party because clause (c) does not specify the nature or extent of that duty.<sup>232</sup>

*Brennan* is a landmark decision because it utilized tort principles while also attempting to analyze aiding and abetting liability in securities law fraud litigation.<sup>233</sup> Moreover, *Brennan's* import relies on the premise that the court rejected a claim that Congress, by implication, excluded aiding and abetting liability from inclusion within the securities laws.<sup>234</sup> The *Brennan* court held that liability under Rule 10b-5 can be imposed on a defendant who is not a primary participant in the fraudulent activity.<sup>235</sup> To reach this conclusion, the court relied upon the fact that the Securities Exchange Act of 1934 had a broad and remedial purpose which should not be "rendered impotent to deal with new and unique situations within the scope of the evils intended to be eliminated."<sup>236</sup> Furthermore, where there exists no legislative statement to the contrary, the statute is to be flexibly applied "so as to implement its policies and purposes."<sup>237</sup> Therefore, concluded the trial court, "it cannot be said that civil liability for damages, . . . may never under any circumstances be imposed upon persons who do no more than aid and abet a violation of Section 10(b) and Rule 10b-5."<sup>238</sup>

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229. RESTATEMENT OF TORTS § 876 comment b, at 436-37 (1939). See also RESTATEMENT (SECOND) OF TORTS § 876, comment b, at 317 (1979).

230. See Ruder, *Multiple Defendants*, *supra* note 1, at 621.

231. RESTATEMENT OF TORTS § 876, comment (c), at 439 (1939). See also RESTATEMENT (SECOND) OF TORTS § 876, comment (c), at 318-19 (1979).

232. Comments to § 876 relate primarily to minor physical harm. See RESTATEMENT (SECOND) OF TORTS § 876 (1979). Professor Ruder warned the reader that § 876 "offers little helpful analysis and properly should be rejected as an independent source of liability under the securities laws." See Ruder, *Multiple Defendants*, *supra* note 1, at 622. Professor Ruder stated: "Since section 876 . . . deals primarily with liability for physical harm rather than liability in the business or economic setting, it should be relied upon with caution in invoking securities law liability." *Id.* at 621.

233. See note 223 and accompanying text *supra*.

234. *Brennan*, 259 F. Supp. at 678-81.

235. *Id.* at 680-81.

236. *Id.*

237. *Id.*

238. *Id.* at 681.

*Elements of Aiding and Abetting Liability*

The first case to establish the tripartite test for determining aiding and abetting liability was *SEC v. Coffey*.<sup>239</sup> In *Coffey*, the SEC brought injunctive proceedings against the chairman of the board and the financial vice president of King Resources Company ("King Resources"), an oil well drilling corporation.<sup>240</sup> King Resources borrowed approximately \$8,000,000 from the State of Ohio, evidenced by the issuance of promissory notes.<sup>241</sup> Shortly thereafter, King Resources collapsed, rendering the notes virtually worthless.<sup>242</sup> The SEC alleged that King Resources and its codefendants misrepresented pertinent financial information and failed to disclose material facts concerning its financial condition and the proposed use of loan proceeds, thereby misleading the State of Ohio.<sup>243</sup> The United States District Court for the Southern District of Ohio granted the injunction, and the defendants appealed.<sup>244</sup>

The Sixth Circuit borrowed heavily from section 876(b) of the *Restatement of Torts* in formulating the elements of an aiding and abetting violation of Rule 10b-5.<sup>245</sup> Essentially, the court required: (a) proof that some other person committed a securities law violation; (b) the aider and abettor had a "general awareness that his role was part of an overall activity that is improper," and (c) the accused "knowingly and substantially assisted the violation."<sup>246</sup> Every circuit addressing aiding and abetting liability under Rule 10b-5 generally has adopted the *Coffey* test.<sup>247</sup> A decade after its introduction, the

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239. 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). See also *Metge*, 762 F.2d at 624. The tripartite test as set out in *Metge* is: (1) the existence of a securities law violation by the primary party (as opposed to the aiding and abetting party); (2) "knowledge" of the violation on the part of the aider and abettor; and (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation. *Id.* See note 30 and accompanying text *supra*.

240. *Coffey*, 493 F.2d at 1308.

241. *Id.*

242. *Id.*

243. *Id.* Ohio relied upon the "prime" rating on King Resources' commercial paper by the National Credit Office, Inc., a division of Dun & Bradstreet. The National Credit Office granted the "prime" rating once its requests for certain information were accepted and followed. At no time was the information from King Resources false. *Id.*

244. *Id.* at 1309-10.

245. *Id.* at 1316.

246. *Id.* See RESTATEMENT OF TORTS § 876(b) comment b (1939). See also RESTATEMENT (SECOND) OF TORTS § 876(b) comment d (1979) (detailing the same elements as in the comment to the original *Restatement*).

247. See, e.g., *Cleary v. Perfectune, Inc.*, 700 F.2d 744, 777 (1st Cir. 1983) (direct cite to *Coffey*); *Harmsen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982) (essentially adopts the *Coffey* test without citing to the case); *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 224 (6th Cir. 1982) (direct cite to *Coffey*); *Stokes v. Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981) (essentially adopts the *Coffey* test without citing to the case); *Investor Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.) (essentially adopts the *Coffey* test

*Coffey* test has evolved into the following foundational elements: (1) proof of a primary violation; (2) a knowledge requirement; and (3) knowing and substantial assistance on the defendant's behalf.<sup>248</sup> These three elements have been limited to aiding and abetting liability under Rule 10b-5 only. Few courts have supported secondary liability in private causes of action under the express liability provisions of the securities statutes.<sup>249</sup>

Originally, the *Coffey* court required proof that some other person committed a securities law violation.<sup>250</sup> In the vernacular, that person is called the "primary violator". Despite an early deviation from this requirement,<sup>251</sup> all circuits that have addressed aiding and abetting liability under Rule 10b-5 require proof of a securities law violation by a primary party.<sup>252</sup> Furthermore, the plaintiff must spe-

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without citing to the case), *cert. denied*, 449 U.S. 919 (1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980) (direct cite to *Coffey*); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595-96 (10th Cir. 1979) (essentially adopts the *Coffey* test without citing to the case); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir.) (essentially adopts the *Coffey* test without citing to the case), *cert. denied*, 439 U.S. 930 (1978); *Woodward*, 522 F.2d at 94-95 (direct cite to *Coffey*).

248. See *Cleary*, 700 F.2d at 777; *Harmsen*, 693 F.2d at 943; *Washington County Util. Dist.*, 676 F.2d at 224; *Monsen*, 579 F.2d at 799; *Woodward*, 522 F.2d at 94-95.

249. See *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1034 (D. Minn. 1981) (rejecting plaintiffs' cause of action under §§ 11 and 12(2) of the Securities Act of 1933); *In re Equity Funding Corp. of America Sec. Litig.*, 416 F. Supp. 161, 181 (C.D. Cal. 1976) (rejecting plaintiffs' cause of action under §§ 11 and 12(2) of the Securities Act of 1933). But see *In re Caesars Palace Sec. Litig.*, 360 F. Supp. 366, 384 (S.D.N.Y. 1973) (interpreting a private cause of action for aiding and abetting in an express liability provision in §§ 11 and 12(2) of the Securities Act of 1933). See generally Aldave, "Neither Unusual nor Unfortunate": *The Overlap of Rule 10b-5 with the Express Liability Sections of the Securities Acts*, 60 TEX. L. REV. 714, 722-27 (1982) (discussing civil remedies for securities law violations under §§ 11, 12(1), 12(2), and 15 of the Securities Act of 1933 and §§ 18 and 20(a) of the Securities Exchange Act of 1934); Note, *supra* note 223, at 1094 n.50 (noting that very few private suits are brought under the other provisions of the federal securities statutes).

250. *Coffey*, 493 F.2d at 1316.

251. See *Landy*, 486 F.2d at 162. The Third Circuit required proof of the existence of "an independent wrong." *Id.* The Fifth Circuit, in *Woodward*, criticized the *Landy* court's use of the phrase "an independent wrong," rather than the *Coffey* court's test of "a securities law violation," stating that the "*Landy* elements pose a danger of over-inclusiveness and seem to lose sight of the necessary connection to the securities laws." *Woodward*, 522 F.2d at 95. Subsequently, the Third Circuit returned to the fold and presently requires proof of the commission of an underlying securities violation. See *Monsen*, 579 F.2d at 799.

252. See, e.g., *Cleary*, 700 F.2d at 777 (requiring proof of "the commission of a violation of § 10(b) or Rule 10b-5 by the primary party"); *Washington County Util. Dist.*, 676 F.2d at 225 (stating that "[t]he initial step in our inquiry is to determine whether a securities violation was committed"); *Stokes*, 644 F.2d at 782 (requiring proof of "the existence of a securities law violation by the primary party [as opposed to the aiding and abetting party]"); *Investors Research Corp.*, 628 F.2d at 178 (endorsing *Woodward* approach); *Cornfeld*, 619 F.2d at 922 (accepting the first element without discussion); *Edward J. Mawod & Co.*, 591 F.2d at 595 (holding that the evidence was sufficient to establish "existence of a scheme to manipulate the price of Epoch stock, which was

cifically identify the primary violator<sup>253</sup> and satisfy the elements of a private cause of action under Rule 10b-5.<sup>254</sup> Normally, short shrift is given to both of these considerations.<sup>255</sup> Therefore, most of the attention in the aiding and abetting cases is concentrated on the other two elements established in *Coffey*.<sup>256</sup>

The second requirement of *Coffey* is that the aider and abettor must have a "general awareness that his role was part of an overall activity that is improper."<sup>257</sup> The third element established by the *Coffey* court requires the plaintiff to prove that the defendant "knowingly and substantially" assisted in the violation of Rule 10b-5.<sup>258</sup> Although the *Coffey* court did not explain its rationale for adopting these requirements, it did cite to *Brennan*, implying that it approved that court's rationale.<sup>259</sup> In *Brennan*, the district court accepted the legal principles of contributing tortfeasors, formulated in section 876 of the *Restatement of Torts* and adopted by federal courts for other districts, because "[s]uch principles . . . surely best fulfill the purposes of the Securities Exchange Act of 1934 and are a logical and natural complement to the *Kardon* doctrine."<sup>260</sup>

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aided and abetted by the petitioners here"); *Monsen*, 579 F.2d at 799 (stating that "plaintiffs have the burden of establishing . . . that there has been a commission of a wrongful act — an underlying securities violation"). *Woodward*, 522 F.2d at 95 (adopting the *Coffey* elements) (quoting *Coffey*, 493 F.2d at 1316).

253. See, e.g., Note, *supra* note 223, at 1095. The author stated: "[T]he alleged violator must be identified specifically so that the court can determine which collateral parties are subject to potential aiding and abetting liability." *Id.*

254. See *Huddleston*, 640 F.2d at 543. Similar to the elements in a civil action for fraud and/or misrepresentation, the elements of a private cause of action under Rule 10b-5 include materiality, reliance, privity, causation, scienter, and identification of buyers and sellers. See *id.* See also *Cameron*, 608 F.2d at 193-94. The Fifth Circuit in *Cameron* held that the elements under Rule 10b-5 are as follows:

A misrepresentation or omission or other fraudulent device, the plaintiff's purchase or sale of securities in connection with the fraudulent device, the materiality of the misrepresentation or omission, the defendant's scienter in making the misrepresentation or omission, the plaintiff's justifiable reliance on the device [or due diligence against it], and the plaintiff's damages resulting from the fraudulent device.

*Id.*

255. See Note, *supra* note 223, at 1095 n.54. The author noted: "Because aiding and abetting theories typically are applied in cases in which the primary violator is insolvent and therefore judgment proof, . . . the liability of the primary violator is rarely an issue." *Id.* (citation omitted).

256. See note 252 *supra*.

257. *Coffey*, 493 F.2d at 1316.

258. *Id.*

259. *Id.* (citing *Brennan*, 259 F. Supp. at 680). See also notes 223-38 and accompanying text *supra*.

260. *Brennan*, 259 F. Supp. at 680 (citing *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 28 (S.D.N.Y. 1963)). This decision was an action for damages wherein the court denied a motion to dismiss and upheld the part of the complaint alleging aiding and abetting liability under § 10(b) and Rule 10b-5 against the defendant stock exchange and its officials. The *Brennan* court reasoned that " 'knowing assistance of or

The Fifth Circuit in *Woodward v. Metro Bank*<sup>261</sup> adopted three distinct factors which determine the extent of a defendant's "knowledge": (a) the general nature of the implicating transaction between the primary violator and the alleged aider and abettor; (b) the type of security central to the transaction; and (c) the existence of a special duty imposed upon the defendant by operation of the securities acts.<sup>262</sup> The court recognized that, where the alleged aider and abettor conducts what appears to be a transaction in the ordinary course of his business, more evidence of his complicity is essential.<sup>263</sup> However, consideration of the transaction requires consideration of the nature of the security.<sup>264</sup> The court added:

Transactions occur as a whole and only later are they subjected to the scalpel of the legal dissector. If the securities involved are shares of common stock and someone aides and abets a fraud perpetrated in their sale, the culprit would be hard pressed to argue innocence once his awareness of the general sales activity was shown. On the other hand, if the document is barely a security at all, like a loan, then other independent commercial assumptions come into play, and the alleged aider-abettor may be unaware of any improper activity.<sup>265</sup>

Furthermore, the Fifth Circuit noted that a court may be influenced by special duties imposed by either of the securities acts on particular types of defendants, such as insiders,<sup>266</sup> controlling persons,<sup>267</sup> ac-

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participation in a fraudulent scheme under section 10(b) gives rise to liability equal to that of the perpetrators themselves. . . ." *Id.* at 677 (quoting *Pettit*, 217 F. Supp. at 28). A private right of action under Rule 10b-5 was first implied in *Kardon*, 69 F. Supp. at 513. For a discussion of the rationale of the *Kardon* decision, see note 4 *supra*.

261. 522 F.2d 84 (5th Cir. 1975).

262. *Id.* at 95-96.

263. *Id.* at 96.

264. *Id.* at 95.

265. *Id.*

266. *See id.* at 96. *See also* *Dirks v. SEC*, 463 U.S. 646, 660 (1983); *Rekant v. Desser*, 425 F.2d 872, 882 (5th Cir. 1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In *Dirks*, the Court held that some tippees must assume a duty of disclosure to the shareholders, not because they receive inside information, but rather because it has been made available to them improperly. *Id.* The Fifth Circuit in *Rekant* held: "This omission violated the directors' duty to disclose fully the material facts relating to the . . . transactions." *Rekant*, 425 F.2d at 882. In *Texas Gulf Sulphur Co.*, the Second Circuit held that one possessing information may not be strictly termed an "insider," but anyone in possession of material, inside information is an "insider" and must either disclose it to the investing public or abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. *Texas Gulf Sulphur Co.*, 401 F.2d 848. But see *Chiarella v. United States*, 445 U.S. 222, 235 (1980). The Court in *Chiarella* held that the plaintiff-printer did not have a duty to disclose under § 10(b) by merely his possessing nonpublic, market information. *Id.*

267. *See* notes 74-212 and accompanying text *supra*. The *Woodward* court cited to

countants,<sup>268</sup> or brokers.<sup>269</sup> However, the securities acts generally do not impose strict liability on all those who come in contact with the security.<sup>270</sup>

In an unprecedented move, the Fifth Circuit stated that the requisite knowledge may be shown by circumstantial evidence, or by reckless conduct.<sup>271</sup> Nevertheless, the court added that the proof must demonstrate the defendant's actual awareness of his role in the fraudulent scheme.<sup>272</sup>

Of the three elements espoused in the *Coffey* decision, the knowledge or general awareness requirement is the most important. Without this requirement, financial institutions, brokerage houses, and other organizations providing mechanical assistance in the ordinary and customary course of business would be virtual insurers of their customers against securities law violations.<sup>273</sup> Therefore, courts have stated that the aider and abettor must have knowledge of the primary violator's illegal conduct, and not just knowledge of the material facts constituting the illegal conduct.<sup>274</sup> Unfortunately, the ap-

§ 15 of the Securities Act of 1933, 15 U.S.C. § 77o (1982), and § 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t (1982). *Woodward*, 522 F.2d at 96 n.25.

268. *Woodward*, 522 F.2d at 96 n.26. See Securities Act of 1933 § 11, 15 U.S.C. § 77k (1982). See also Securities Exchange Act of 1934 § 18, 15 U.S.C. § 78r (1982) (providing liability for filing misleading statements).

269. *Woodward*, 522 F.2d at 96 n.27. See Securities Exchange Act of 1934 §§ 11, 15, 15 U.S.C. §§ 78k, 78o (1982). See also Stern, *Potential Liability of Purchaser Representatives*, 39 BUS. LAW. 1801, 1827 (1984). The author noted that, under § 15(c)(1) and (c)(2), a broker is prohibited from attempting to induce a purchase or sale of a security, otherwise than on a national securities exchange of which it is a member, by any manipulative, deceptive, or other fraudulent device or contrivance. *Id.* Unlike § 10(b) and Rule 10b-5, § 15(c) applies to offers in addition to actual sales. *Id.*

270. *Woodward*, 522 F.2d at 96. The court stated: "The postman who mails a fraudulent letter is not covered by the Act, nor is the company that manufactured the paper on which the violating documents are printed." *Id.*

271. *Id.*

272. *Id.*

273. See Ruder, *Multiple Defendants*, *supra* note 1, at 630-31. Professor Ruder stated:

If all that is required in order to impose liability for aiding and abetting is that illegal activity under the securities laws exists and that a secondary defendant, such as a bank, gave aid to that illegal activity, the act of loaning funds to the market manipulator would clearly fall within that category and would expose the bank to liability for aiding and abetting. Imposition of such liability upon banks would virtually make them insurers regarding the conduct of insiders to whom they loan money. If it is assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. Knowledge of wrongful purpose thus becomes a crucial element in aiding and abetting or conspiracy cases.

*Id.*

274. See *Monsen*, 579 F.2d at 799; *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 826-27 (E.D. Wis. 1977). But see *Gould v. American-Hawaiian S.S. Co.*, 535

plication of this principle is particularly difficult in the context of aiding and abetting claims that are premised on silence or inaction by the participating defendant.<sup>275</sup> The United States Supreme Court's decision in *Ernst & Ernst v. Hochfelder*<sup>276</sup> has further complicated the process.

In *Hochfelder*, the Court dismissed an action against an accounting firm which allegedly had aided and abetted the fraud of an employee of a brokerage firm, by negligently failing to discover the fraud in the course of its audit of the firm.<sup>277</sup> The Court held that scienter is a necessary element of a cause of action under section 10(b) of the 1934 Act and Rule 10b-5.<sup>278</sup> The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."<sup>279</sup> Proof of more than negligence is a precondition to the imposition of civil liability under section 10(b) and Rule 10b-5.<sup>280</sup> The Court specifically reserved the question of "whether, in some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5."<sup>281</sup> However, a growing number of circuits have answered this issue in the affirmative.<sup>282</sup>

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F.2d 761, 779-80 (3d Cir. 1976) (holding that the "requirement of knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing").

275. See, e.g., *Woodward*, 522 F.2d at 96. The court stated: "Most problematic in this area is the issue whether, or to what extent, silence and inaction can fulfill the requirement." *Id.* The standards courts have used for measuring culpability by silence have varied. *Id.* Some declare, without qualification, that silence can create aiding and abetting liability. *Id.* Other courts squarely reject the notion that inaction alone is enough. See, e.g., *Coffey*, 493 F.2d at 1317 (imposing liability only where it is shown that the accused aider and abettor consciously intended to further the securities law violation through his silence). See also *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973) (holding that liability for silence or inaction arises only when defendant has a duty of disclosure).

276. 425 U.S. 185 (1976).

277. *Id.* at 188-89.

278. *Id.* at 193 n.12. Curiously, the Court had the opportunity to decide whether recklessness and negligence sufficiently manifest the element of scienter; however, it relegated the crux of the scienter element to a mere footnote. See *id.* at 193 n.12. In *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court extended the element of scienter to public enforcement actions brought by the SEC for a Rule 10b-5 violation. *Id.* at 695. See also notes 347-52 and accompanying text *infra* (regarding the Court's inability to address adequately the issue of scienter, thereby causing great consternation among the circuit courts of appeals).

279. *Hochfelder*, 425 U.S. at 193 n.12.

280. See *id.* at 215.

281. *Id.* at 193 n.12. After defining scienter, the majority opinion offered the following statement: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id.*

282. See *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976) (stating the definition of recklessness applied by the various circuits). See also *Dirks v. SEC*, 681 F.2d 824, 844-45 (D.C. Cir. 1982) (holding that recklessness satisfies the knowing assistance test of *Woodward* or the general awareness test of *Coffey*).

Several courts have held that scienter in an aiding and abetting case can be established by proof of recklessness, especially where the alleged aider and abettor owes a duty to the plaintiff.<sup>283</sup> Conversely, "the scienter requirement scales upward when activity is more remote."<sup>284</sup> Under this view, "if the alleged aider and abettor conducts what appears to be a transaction in the ordinary course of his business more evidence of his complicity is essential."<sup>285</sup> Currently, no court has held that scienter requires proof of actual knowledge of all the material facts of the violation.

The third element from *Coffey* requires the plaintiff to prove that the aider and abettor "knowingly and substantially assisted" the person perpetrating the primary violation.<sup>286</sup> Originally, the Third Circuit omitted the word "knowing" from the third element in *Landy v. FDIC*.<sup>287</sup> However, in *Woodward v. Metro Bank*<sup>288</sup> the Fifth Circuit criticized this omission as dangerously "over-inclusive" when the first two *Landy* elements were viewed in conjunction with this oversight:

One could know of the existence of a "wrong" without being aware of his role in the scheme, and it is the participation that is at issue. The scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing. A remote

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*rev'd on other grounds*, 463 U.S. 646 (1983); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982) (accepting the recklessness standard without extended discussion); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (holding that recklessness constitutes sufficient scienter for § 10(b) and Rule 10b-5); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (holding that, where a stockbroker owes a direct fiduciary duty of loyalty to his client, recklessness satisfies the Rule 10b-5 scienter requirement), *cert. denied*, 431 U.S. 1039 (1978). *But see Cleary*, 700 F.2d at 777 (imposing liability on the basis of a recklessness standard, where a defendant has a duty to disclose the primary violations); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979) (holding that recklessness may be an appropriate standard for scienter when there is a fiduciary duty), *cert. denied*, 444 U.S. 1045 (1980). *See generally Kaler, Scienter After Hochfelder: Recklessness As a Standard in Rule 10b-5 Private Damage Actions*, 6 J. CORP. L. 337, 342-44 (1981) (examining recklessness as a standard of scienter after *Hochfelder*); Note, *supra* note 223, at 1100-04 (noting discrepancy with respect to the various circuits' treatment of this issue).

283. *See Stokes*, 644 F.2d at 783; *Cornfeld*, 619 F.2d at 923; *Edward J. Mawod & Co.*, 591 F.2d at 596; *Rolf*, 570 F.2d at 44; *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith*, 464 F. Supp. 528, 537 (D. Md. 1978); *Stern*, 429 F. Supp. at 825.

284. *Woodward*, 522 F.2d at 95.

285. *Id.*

286. *Coffey*, 493 F.2d at 1316.

287. *See Landy v. FDIC*, 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). The Third Circuit offered the following three elements: (1) that an independent wrong exists; (2) that the aider and abettor knows of that wrong's existence; and (3) that substantial assistance is given in effecting that wrong. *Id.*

288. 522 F.2d 84 (5th Cir. 1975).

party must not only be aware of his role, but he should also know when and to what degree he is furthering the fraud.<sup>289</sup>

Shortly thereafter, the Third Circuit adopted the *Coffey* test requiring the assistance to be both substantial and known.<sup>290</sup> Despite its relatively uniform acceptance,<sup>291</sup> the federal courts have had considerable difficulty in applying the third element of the *Coffey* test.<sup>292</sup> Specifically, the question has arisen as to the amount of assistance required to impute aider and abettor liability.<sup>293</sup> The courts have failed to establish meaningful guidelines for determining when conduct is "substantial."

The standard for substantial assistance lies somewhere between slight assistance, where liability might not be imposed, and direct participation, where the defendant's conduct approaches a primary violation of the securities laws by itself. In *Landy* and *Monsen*, the Third Circuit relied on the *Restatement of Torts* to determine if the defendant's conduct was sufficiently substantial to impute liability.<sup>294</sup> Section 876 of the *Restatement (Second) of Torts* suggests that in determining if the assistance is substantial enough to make an individual liable for the act of another, the courts should consider the following five factors: (1) the nature of the act encouraged; (2) the amount of assistance given by the defendant; (3) the defendant's presence or absence at the time of the tort; (4) the defendant's relation to the primary tortfeasor; and (5) the defendant's state of mind.<sup>295</sup> The "state of mind" criterion suggests that "substantial assistance" implies knowledge of the independent wrong.<sup>296</sup> The *Landy* court noted that the "state of mind" criterion may suggest no

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289. *Id.* at 95.

290. See *American-Hawaiian S.S. Co.*, 535 F.2d at 779. The court stated: "[P]laintiffs . . . have the burden of proving the doing of a wrongful act, the alleged aiders 'and abettors' knowledge of it and their knowing and substantial participation in the wrongdoing." *Id.* (citations omitted). See also *Rochez Bros.*, 527 F.2d at 886 (stating the third element alternatively as "substantial assistance in effecting" the wrongful act).

291. See *Cleary*, 700 F.2d at 778; *Harmsen*, 693 F.2d at 943; *Washington County Util. Dist.*, 676 F.2d at 224; *Stokes*, 644 F.2d at 782-83; *Investors Research Corp.*, 628 F.2d at 178; *Cornfeld*, 619 F.2d at 922; *Edward J. Mawod & Co.*, 591 F.2d at 595-96; *Monsen*, 579 F.2d at 799; *Woodward*, 522 F.2d at 94-95.

292. Compare *Cornfeld*, 619 F.2d at 925 (finding knowing and substantial assistance where the aider and abettor had an independent duty of disclosure and remained silent) with *Kerbs v. Fall River Indus.*, 502 F.2d 731, 740 (10th Cir. 1974) (holding that one who aids and abets a fraudulent scheme may be held accountable even though his assistance consists of mere silence or inaction).

293. See *Metge*, 762 F.2d at 624-25.

294. See *Monsen*, 579 F.2d at 800; *Landy*, 486 F.2d at 162.

295. See RESTATEMENT (SECOND) OF TORTS § 876 comment c (1977).

296. See *Monsen*, 579 F.2d at 800. While considering the defendant's state of mind, the court held that the evidence failed to show any intent by the defendant to further a securities violation. *Id.*

liability where the defendant's assistance was intended to achieve other independent and legitimate goals.<sup>297</sup> The *Woodward* court accepted this rationale and held that where "evidence shows no more than transactions constituting the daily grist of the mill" the Fifth Circuit will refuse to impute aider and abettor liability "without clear proof of intent to violate the securities laws."<sup>298</sup> On the other hand, if the method lacks any business justification, it may be possible to infer the knowledge element necessary to impute aiding and abetting liability.<sup>299</sup> The court stated that "[i]n any case, the assistance must be substantial before liability can be imposed under Rule 10b-5."<sup>300</sup>

It is uncertain how much assistance is "substantial" assistance. This question goes to the second factor stated in section 876 of the *Restatement (Second) of Torts*.<sup>301</sup> For example, in *Anderson v. Francis I. DuPont & Co.*<sup>302</sup> the court held that two securities dealers could be sued by the customers of a commodities pool operator under allegations of substantial assistance simply by giving the operator office space, endorsing his skill and standing as a commodities trader, and holding him out as a favored and valued customer.<sup>303</sup> Substantial assistance also has been found where an issuer's accountants recommended using falsified financial reports which were neither prepared nor certified by those accountants.<sup>304</sup>

The Second Circuit utilized a "but for" standard of causation to link the defendant's conduct to the primary violator's fraudulent activity in *Rolf v. Blyth, Eastman Dillon & Co.*<sup>305</sup> The Second Circuit reasoned that the defendant broker's acts were the "substantial causal factor" in the perpetration of the primary violator's fraud, and were sufficient to impute the broker with aider and abettor liability.<sup>306</sup> The broker repeatedly reassured an investor of his investment adviser's competence, processed many of the securities orders, and either recklessly failed to learn of, or failed to disclose, the adviser's

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297. *Landy*, 486 F.2d at 163.

298. *Woodward*, 522 F.2d at 97.

299. *Id.*

300. *Id.*

301. See note 295 and accompanying text *supra*.

302. 291 F. Supp. 705 (D. Minn. 1968).

303. *Id.* at 709.

304. *Fischer v. Kletz*, 266 F. Supp. 180, 197 (S.D.N.Y. 1967). The court expressed doubt as to whether the accountant's "assistance or encouragement" was "substantial" in the sense contemplated by § 876 of the *Restatement (Second) of Torts*. *Id.* However, it would have been inappropriate to make that determination before trial; therefore, the court denied the defendant's motion to dismiss. *Id.*

305. 570 F.2d 38, 48 (2d Cir.) (finding that effect of defendant's activities prevented discovery of the fraud), *cert. denied*, 439 U.S. 1039 (1978).

306. *Id.*

fraudulent mismanagement of the investor's portfolio.<sup>307</sup> In *Fund of Funds, Ltd. v. Arthur Andersen & Co.*,<sup>308</sup> the district court held that Arthur Andersen had assisted a Rule 10b-5 violation by serving as the independent auditor for both the primary violator and the plaintiff.<sup>309</sup> The court noted that Arthur Andersen had direct responsibility for determining the accuracy of the corporate records and disclosing any financial irregularities, which it failed to do.<sup>310</sup> Furthermore, the accounting firm's failure "lulled" the plaintiff into a false sense of security.<sup>311</sup> Consequently, the court held that Arthur Andersen proximately caused the plaintiff's damages.<sup>312</sup> Notwithstanding these isolated cases, the "but for" standard of causation has received little or no support in other circuits.

The issue of whether a person can be held liable as an aider and abettor when his sole assistance was through silence and inaction has not been uniformly resolved.<sup>313</sup> Some courts have held that aider and abettor liability can arise out of silence or inaction where the defendant remained silent with a conscious intention to further the fraudulent activity.<sup>314</sup> However, several courts have imputed aider and abettor liability for silence and inaction only where the defendant had an independent duty to disclose the securities violation.<sup>315</sup> In *Woodward*, the Fifth Circuit settled for an amalgamation of these two tests, stating that it will impute aider and abettor liability for silence and inaction when the defendant either specifically intended to

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307. *Id.*

308. 545 F. Supp. 1314 (S.D.N.Y. 1982).

309. *Id.* at 1356.

310. *Id.* at 1357-58.

311. *Id.* at 1358.

312. *Id.* at 1359.

313. See *Kerbs*, 502 F.2d at 740. Initially, aiding and abetting liability predicated on silence and inaction received a lukewarm reception among the circuits. Compare *Landy*, 486 F.2d at 163-64 (rejecting aiding and abetting liability based on silence) with *Brennan*, 259 F. Supp. at 678 (indicating that an aider and abettor could be liable for either action or omission). See also *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364, 374 (7th Cir.) (holding that aider and abettor must be shown to have possessed "knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to . . . [a] breach of a duty of disclosure"), *cert. denied*, 419 U.S. 875 (1974).

314. See *Cornfeld*, 619 F.2d at 926; *Rochez Bros.*, 527 F.2d at 889; *Coffey*, 493 F.2d at 1317.

315. See *Steachman v. SEC*, 603 F.2d 1126, 1140-41 (5th Cir. 1979); *Edwards & Hanley*, 602 F.2d at 484-85; *Kerbs*, 502 F.2d at 740; *Lanza*, 479 F.2d at 1289; *Strong*, 474 F.2d at 752; *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971); *Peoples Nat'l Bank v. Nichols*, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 92,284, at 91,953 (D. Or. July 10, 1985); *Quintel Corp., N.V. v. Citibank, N.A.*, 589 F. Supp. 1235, 1244-45 (S.D.N.Y. 1984); *Dahl v. Gardner*, 583 F. Supp. 1262, 1267 (D. Utah 1984); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 712 (D.D.C. 1978); *Stern*, 429 F. Supp. at 825; *Green v. Jonhop, Inc.*, 358 F. Supp. 413, 419 (D. Or. 1973); *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

further the fraud or had an independent duty to disclose the facts underlying the primary securities violation.<sup>316</sup> No rationale was given by the *Woodward* court to support its conclusion. However, courts have adopted this holding in subsequent cases.<sup>317</sup> Furthermore, no Eighth Circuit decisions had addressed the issue of substantial assistance and inactivity or silence prior to *Metge*.

## ANALYSIS

### METGE ON CONTROLLING PERSON LIABILITY

The Eighth Circuit adopted the two-point test formulated in *Stern v. American Bankshares Corp.*<sup>318</sup> to impute controlling person liability. That test requires "that the defendant lender 'actually participated in (i.e., exercised control over) the operations of the corporation in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised.'"<sup>319</sup> Two reasons were cited by the Eighth Circuit in support of its adoption of the *Stern* test. First, the test complies with *Myzel v. Fields*,<sup>320</sup> which advocated broad remedial construction for the securities acts. Second, sections 15 of the 1933 Act and 20(a) of the 1934 Act do not require participation in the securities violation. Furthermore, since good faith and lack of participation are affirmative defenses in a controlling person action, to require the plaintiff to prove them as part of his *prima facie* case while allowing them as affirmative defenses, "confuses the parties' responsibilities and unnecessarily burdens plaintiffs contrary to the plain meaning of the statute."<sup>321</sup>

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316. *Woodward*, 522 F.2d at 97. The court stated:

We think that the best solution is a blend of the *Coffey* test and the *Strong* test. When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter.

*Id.*

317. See, e.g., *Dirks*, 681 F.2d at 844-46 (holding that the defendant violated Rule 10b-5 as an aider and abettor by failing to disclose the existence of fraud when he had "a duty to the public and the SEC not to foster the sale of fraudulent or worthless securities"), *rev'd*, 463 U.S. 646, 667 (1983) (holding that defendant had no duty to disclose the fraudulent activity); *Cornfeld*, 619 F.2d at 927 (holding that inaction can create aider and abettor liability only when there is a conscious or reckless violation of an independent duty to act).

318. 429 F. Supp. 818, 824 (E.D. Wis. 1977). See note 113 *supra*.

319. *Metge*, 762 F.2d at 631 (quoting *Metge*, 577 F. Supp. at 817-18). See also *Stern*, 429 F. Supp. at 824 (requiring proof that a defendant actively participated in the operations of the company and possessed actual control over the questionable transaction).

320. 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

321. *Metge*, 762 F.2d at 631 (citing *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945,

The Eighth Circuit noted that the plaintiff's evidence suggested the potential to influence control over IEI's business decisions.<sup>322</sup> However, it was insufficient to show proof of actual control over the corporation in general.<sup>323</sup>

The problem with the second prong of the *Metge* test is that it approaches a control-by-status test.<sup>324</sup> The Eighth Circuit's analysis does not require a court to consider whether the secondary defendant actually controlled the transaction in question. Rather, a showing of the mere potential to control that questionable transaction will suffice. Proof that such control was exercised is not required. A "legal presumption of control" over the primary violator's activity is sufficient to establish indirect control over the primary violator.<sup>325</sup> If all that is needed to impose liability under the controlling person provisions is proof of actual control over the primary violator's operations in general and potential control over the transaction upon which the primary violation is predicated, then the act of loaning funds to the market manipulator would clearly fall within that category and thereby expose the lender to liability under the controlling person provisions. Something more than mere possession of, or the potential for, power to influence and control the primary violator's activity should be required. The necessary ingredient should be proof of culpable participation. Thus, the lender must in some meaningful sense culpably participate in the fraud perpetrated by the primary violator-borrower-controlled person. A knowing exercise of actual power to influence and control the primary violator's activity is sufficient to impute such "guilty" participation. Concentrating on the secondary defendant's possession of, or potential for, power to control and influence the primary violator's action indicates that the defendant's status, and not a knowing exercise of power, is the crucial factor.

A control-by-status test ignores the legislative history of sections 15 and 20(a). Again, the control-by-status standard imposes a strict liability theory in securities law.<sup>326</sup> Plaintiffs need not allege intent since negligence will suffice to impute controlling person liability. Although courts could feasibly argue that reference to a "legally enforceable control" found in the legislative history to section 20(a)

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957-58 (5th Cir. 1981)). See *Metge*, 577 F. Supp. at 815-16. See also notes 141-212 and accompanying text *supra*.

322. *Metge*, 762 F.2d at 632.

323. *Id.*

324. See notes 102-112 and accompanying text *supra*.

325. Note, *supra* note 101, at 1022. The author stated: "This is not to say that questions of fact will be irrelevant in cases applying the control-by-status standard. In *Moerman*, the controlling defendants escaped liability via the good-faith defense." *Id.* at 1022 n.28. See notes 105-07 and accompanying text *supra*.

326. See note 109 and accompanying text *supra*.

could support imposition of a strict liability theory, a closer reading of that legislative history indicates that the actual control standard clearly reflects congressional intent.<sup>327</sup> In the House Report filed upon the completion of deliberations of the 1934 Securities Exchange Act, Congress stated: "In this section . . . when reference is made to 'control,' the term is intended to include actual control as well as what has been called legally enforceable control."<sup>328</sup> Congress cited to the United States Supreme Court case of *Handy & Harman v. Burnet*.<sup>329</sup> The Court looked not at "legally enforceable" alone. Rather, the opinion indicates that the court was looking for evidence of actual control:

[S]hareholders . . . through their power over [the president's] official position and salary, their ability to dominate both corporations or by other means, were in position effectually to influence him in respect of the voting, use or disposition of the stock issued to him, and thus as a practical matter to exert a kind of control called by counsel "actual" to distinguish it from a legally enforceable control.<sup>330</sup>

As actual control was the center of the Court's attention in *Handy & Harman* and Congress cited to *Handy & Harman* in its final report, actual control rather than potential control or control-by-status should be the proper measure for liability under section 20(a).

Furthermore, a control-by-status standard could include a wide variety of persons "with little or no voice in the operation" of the primary violator's institution.<sup>331</sup> Although the first part of the *Metge* test requires proof of actual control over the operations of the primary violator, establishing a control-by-status standard creates potential problems. The list of potential "deep pocket" defendants could include customers with a substantial interest in the corporation of creditors, such as BTC, who possess a substantial block of pledged voting stock as collateral for a loan.<sup>332</sup> If nothing more than the defendant's status need be shown by the plaintiff, then the "dynamic balance between the policy of investor protection and legitimate competing interests of honest business" shifts intolerably toward investor protection.<sup>333</sup> Such a consequence is unfair to the defendant particularly since a section 20(a) plaintiff "need not proceed against the principal perpetrator, nor need the principal perpetrator be identified

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327. See note 111 and accompanying text *supra*.

328. H.R. REP. NO. 1383, *supra* note 57, at 26. See notes 89, 109 and accompanying text *supra*.

329. 284 U.S. 136 (1931). See notes 89, 110 and accompanying text *supra*.

330. *Handy & Harman*, 284 U.S. at 140. See note 111 and accompanying text *supra*.

331. See note 137 and accompanying text *supra*.

332. See Note, *supra* note 101, at 1024.

333. See note 139 and accompanying text *supra*.

in the complaint.<sup>334</sup>

A potential control, or control-by-status, standard approaches a negligence standard. Consequently, the defenses of good faith, lack of participation, and lack of knowledge do not apply since negligence by itself does not require the plaintiff to allege intent. This would render the caveat of good faith and non-inducement found in section 20(a) virtually meaningless.<sup>335</sup> One of the primary canons of statutory interpretation is to avoid a construction rendering a statute nugatory.<sup>336</sup> A potential-control standard found in the second prong of the *Metge* test violates this canon.

Since the Eighth Circuit accepted the potential-for-control test found in the second prong of the *Metge* analysis, it is not a broad leap in logic to recognize the doctrine of *respondeat superior* and principles of agency under section 20(a); both theories rely on the negligence measure. Consequently, the Eighth Circuit would join the list of circuits utilizing *respondeat superior* and agency principles to impute controlling person liability.<sup>337</sup> However, the 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.<sup>338</sup> The use of *respondeat superior* to impute secondary liability to controlling persons would not advance the legislative intent of the 1934 Act. Even though natural persons have duties imposed on them for the protection of the public interest, to impose strict liability on control persons would violate legislative intent.<sup>339</sup>

Both Houses of Congress advanced their own version of the controlling person provisions.<sup>340</sup> The Senate bill proposed an "insurer's

334. See *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170 n.47 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). See also note 140 and accompanying text *supra*.

335. See note 59 and accompanying text *supra*.

336. See *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 163 (1982). The Court declined to construe § 5(a) of the Home Owner's Loan Act of 1933 so as to render it nugatory, "thereby offending the well-settled rule that all parts of a statute, if possible are to be given effect." *Id.* See also *Heckler v. Matthews*, 104 S. Ct. 1387, 1394 (1984).

337. See note 162 and accompanying text *supra*.

338. See H.R. REP. NO. 1383, *supra* note 57, at 1-5.

339. See *Rochez Bros.*, 527 F.2d at 885-86. The *Rochez Bros.* Court held that applying the *respondeat superior* doctrine imposes a duty that would make corporations primarily liable for any security law violation by any officer or employee of the corporation. *Id.* The Third Circuit believed that Congress did not intend to expand liability to this degree when it passed the Securities Exchange Act. *Id.* See also *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973). But see *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981).

340. Compare S. REP. NO. 47, 73d Cong., 1st Sess. 5, 32-33 (1933) with H.R. REP. NO. 152, 73d Cong., 1st Sess. 27 (1933) and H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933).

liability" standard.<sup>341</sup> Conversely, the House opted for a "fiduciary standard," generally providing a due care defense for those subjected to liability under that section.<sup>342</sup> However, since the House version was adopted, this was an indication that "Congress did not intend anyone to be an insurer against the fraudulent activities of another."<sup>343</sup> Therefore, as the Third Circuit said in *Rochez Brothers Inc. v. Rhodes*:<sup>344</sup> "What Congress did intend was to impose liability on those who were controlling persons and who were 'in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.'"<sup>345</sup> This indicates that the "more restrictive 'culpable participation' requirement, which requires a showing that the lender actually participated in the alleged violation,"<sup>346</sup> is the proper standard when viewed in conjunction with the legislative history of the Securities Exchange Act of 1934.

#### METGE ON AIDING AND ABETTING LIABILITY

The Eighth Circuit initially set forth its version of the three-pronged *Coffey* test to establish aiding and abetting liability in *Stokes v. Lokken*.<sup>347</sup> In that case, the three prerequisites were: "(1) the existence of a securities law violation by the primary party (as opposed to the aiding and abetting party); (2) 'knowledge' of the violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation."<sup>348</sup> Conversely, the elements espoused in *Woodward* and *Monsen* are: (1) proof that there has been a commission of a wrongful act — an underlying securities violation; (2) that the alleged aider and abettor had knowledge of that act; and (3) that the aider and abettor *knowingly and substantially* participated in the wrong doing.<sup>349</sup> The only other circuit to utilize the *Stokes-Metge* va-

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See also *Rochez Bros.*, 527 F.2d at 885 (stating that the House and Senate each advanced its own version of what standard should govern controlling persons).

341. See S. REP. NO. 47, *supra* note 340, at 5, 32-33.

342. *Rochez Bros.*, 527 F.2d at 885.

343. *Id.*

344. 527 F.2d 880 (3d Cir. 1975).

345. *Id.* at 885 (quoting *Lanza*, 479 F.2d at 1299).

346. *Metge*, 762 F.2d at 631 (citing *Rochez Bros.*, 527 F.2d at 889-90; *Gordon v. Burr*, 506 F.2d 1080, 1085-86 (2d Cir. 1974)). The *Metge* court rejected the culpable participation requirement for reasons announced by the Fifth Circuit in *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981). See notes 66-68 and accompanying text *supra*.

347. 644 F.2d 779, 782-83 (8th Cir. 1981). See note 247 and accompanying text *supra*. An analysis of the *Stokes* decision and its effect on securities lawyers' liability under § 10(b) can be found in Note, *Stokes v. Lokken: Attorney Liability Under Rule 10b-5*, 15 CREIGHTON L. REV. 1027 (1982).

348. *Stokes*, 644 F.2d at 782-83.

349. See *Monsen*, 579 F.2d at 799; *Woodward*, 522 F.2d at 94-95.

riation has been the Second Circuit in *IIT v. Cornfeld*.<sup>350</sup> A cursory glance at the *Metge* test indicates that the Second and Eighth Circuits omitted the key word "knowing" from the third prong. Furthermore, both the *Stokes-Metge-IIT* and the *Woodward-Monsen* variations have substituted the *Coffey* court's requirement of "general awareness" for that of "knowledge".<sup>351</sup> While the substitution may be trivial, the omission is not. The Eighth Circuit's interpretation and implementation of the *Woodward* and *Coffey* analyses dangerously approaches a negligence standard in contravention of the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*.<sup>352</sup>

Prior to enumerating the three-prong test in *Stokes*, the Eighth Circuit noted that there can be no aiding and abetting liability if proof of any one of these elements was lacking.<sup>353</sup> The district court's opinion in *Metge* echoed the *Stokes* warning, but it did not appear in the Eighth Circuit's opinion on appeal.<sup>354</sup> However, both courts quoted approvingly from *Stokes*' application of an inversely relational analysis.<sup>355</sup> Essentially, the analysis requires the court to consider the three factors in relation to one another and not in isolation: "[T]he two factors [second and third] vary inversely relative to one another and where . . . the evidence of substantial assistance is slim, the requirement of knowledge or scienter is enhanced accordingly."<sup>356</sup> The Eighth Circuit relied on the Fifth Circuit's balancing approach espoused in *Woodward*: "[W]here there exists a minimal showing of substantial assistance, a greater showing of scienter is required."<sup>357</sup> However, it is not certain whether the *Metge* court interpreted *Woodward* as combining the second requirement of general awareness or knowledge with the third requirement of "knowing and substantial" assistance, or whether the *Woodward* court was simply criticizing the *Landy* court for omitting the term "knowing" from the third requirement. Logic appears to support the latter interpretation.

The *Metge* court reasoned that the balancing approach refers to an amalgamation of the general awareness requirement of the second

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350. 619 F.2d 909, 922 (2d Cir. 1980).

351. Compare *Monsen*, 579 F.2d at 799 (holding that the second prong of the *Coffey* test requires proof of general awareness by the accused party) with *Stokes*, 644 F.2d at 782 (holding that the second prong of the aider and abettor test is that of "knowledge," rather than of general awareness, by the accused party). The Eighth Circuit circumvented the *Coffey* test by substituting knowledge for general awareness in the second prong of this test, thereby imposing a more stringent *prima facie* case.

352. 425 U.S. 185, 193 n.12 (1976). See notes 276-80 and accompanying text *supra*.

353. *Stokes*, 644 F.2d at 782.

354. *Metge*, 577 F. Supp. at 820 (citing *Stokes*, 644 F.2d at 782, 784).

355. See *Metge*, 762 F.2d at 624 (citing *Stokes*, 644 F.2d at 784); *Metge*, 577 F. Supp. at 820 (citing *Stokes*, 644 F.2d at 784).

356. *Metge*, 762 F.2d at 624.

357. *Stokes*, 644 F.2d at 784 (citing *Woodward*, 522 F.2d at 95).

prong and the "knowing" element of the third prong. If this is true, then proof by the plaintiff of a great deal of knowledge and no assistance may be enough to impute aiding and abetting liability. This directly contradicts the Eighth Circuit's decision to require proof of all three prongs before aiding and abetting liability will arise.<sup>358</sup> Conversely, if the defendant did not know that its acts, either affirmative conduct or inaction, substantially assisted in the violation's perpetration, then applying *Metge's* interpretation of the balancing approach imputes aider and abettor liability. This interpretation dangerously approaches a negligence standard for aiding and abetting liability which *Ernst & Ernst* specifically forbade.<sup>359</sup> Therefore, the *Woodward* court must have been criticizing the *Landy* court's omission of the term "knowing" from the third requirement.

Perhaps the same criticism could be leveled against the *Stokes-Metge* variation of the three-pronged test. To paraphrase the *Woodward* court, one could know of the existence of a securities violation without being aware of his role in the scheme.<sup>360</sup> However, a remote party must not only be aware of his role, but should also know when and to what degree he is furthering the fraud.<sup>361</sup>

Regarding the "substantial assistance" factor, the Eighth Circuit joins the list of those few courts that require the plaintiff to prove that the aider and abettor proximately caused the violation.<sup>362</sup> In approving this standard, the Eighth Circuit relied on decisions of other courts that have required a showing of "substantial causal connection between the culpable conduct of the alleged aider and abettor and the harm to the plaintiff,"<sup>363</sup> or a showing that "the encouragement or assistance is a substantial factor in causing the resulting tort."<sup>364</sup> Consequently, the *Metge* court specifically rejected a showing of a

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358. See *Stokes*, 644 F.2d at 782. See note 353 and accompanying text *supra*.

359. See notes 276-80 and accompanying text *supra*.

360. See *Woodward*, 522 F.2d at 95.

361. *Id.*

362. See, e.g., *Mendelsohn v. Capital Underwriters, Inc.*, 490 F. Supp. 1069, 1084 (N.D. Cal. 1979) (holding that plaintiff must make some factual showing of a substantial causal connection between the alleged aider and abettor's assistance and the harm to the plaintiff); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705, 709 (D. Minn. 1968) (upholding complaint alleging that defendants as aiders and abettors gave an offending dealer office space, endorsed his skill and standing as a commodities trader, and held him out as a favored and valued customer). See also *Landy v. FDIC*, 486 F.2d 139, 163 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (premising liability on facts which equate "substantial assistance" with a business transaction, which foreseeably permits one of the parties to the transaction to independently engage in illegal action as to other parties).

363. *Mendelsohn*, 490 F. Supp. at 1084.

364. *Landy*, 486 F.2d at 163 (erroneously quoting *Restatement of Torts* § 436). The statement to which the *Landy* court was referring can be found at RESTATEMENT OF TORTS § 876 comment b, at 436-37 (1939).

"but for" causation.<sup>365</sup> Under that test the aider and abettor must be shown to have possessed "knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the [defendant] failed to act due to an improper motive or breach of a duty of disclosure."<sup>366</sup> In *Metge*, it was clear that BTC was under no obligation to inquire any further into IEI's business affairs.<sup>367</sup> Furthermore, had BTC disclosed sensitive financial data between BTC and IEI, it might have violated or federal laws protecting IEI's right to financial privacy.<sup>368</sup>

Support for *Metge's* decision to require proof of proximate causation may be found in comment b to section 876 of the *Restatement of Torts*,<sup>369</sup> which provides: "If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences for the other's acts."<sup>370</sup> Therefore, the law in the Eighth Circuit now requires a substantial causal connection between the culpable conduct of the defendant and the harm to the plaintiff.<sup>371</sup> Consequently, in order for the plaintiff to defeat a motion for summary judgment he must make some factual showing that the aider and abettor's assistance was a substantial factor in bringing about the violation.<sup>372</sup>

Viewing the facts in the *Metge* case in the light most favorable to the plaintiff, it is apparent that BTC's services were not a substantial factor in causing the alleged Rule 10b-5 violation. BTC's demand for collateral when making loans is an ordinary banking practice that has no connection with the securities fraud. BTC's efforts to keep IEI alive when delinquencies occurred may be sufficient to show "but for" causation; that is, but for the continued existence of IEI, the securities violation could not have continued.<sup>373</sup> However, the fraud

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365. See *Metge*, 762 F.2d at 624. See also *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 48 (2d Cir.) (specifically approving a "but for" standard of causation), cert. denied, 439 U.S. 1039 (1978).

366. See *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364, 374 (7th Cir.), cert. denied, 419 U.S. 875 (1974).

367. *Metge*, 762 F.2d at 625. The Eighth Circuit acknowledged that the law did not impose a duty of disclosure on the secondary defendant in this case. *Id.*

368. See 12 U.S.C. § 3403(a) (1982). The statute states: "No financial institution, or officer, employees, or agent of a financial institution, may provide to any government authority access to or copies of, or the information contained in, the financial records of any customer except in accordance with the provisions of this chapter." See also 15 U.S.C. § 78u(h)(1)-(13) (1982) (specifically limits the SEC's access to financial records held by financial institutions unless it follows required procedure).

369. RESTATEMENT OF TORTS § 876 comment b (1939).

370. *Id.*

371. See, e.g., *Mendelsohn*, 490 F. Supp. at 1084 (requiring a causal connection between the culpable conduct of the alleged aider and abettor and the plaintiff's harm).

372. See *id.*

373. *Metge*, 577 F. Supp. at 821 n.9.

was not a reasonably foreseeable consequence of BTC's efforts. As the *Landy* court noted, if the defendant's assistance was intended to achieve other independent and legitimate goals, then no liability could arise.<sup>374</sup>

The question arises whether BTC's silence and inaction could fulfill the substantial assistance requirement. Specifically, the fact that BTC did not act to halt the thrift certificate program, or make disclosures to purchasers of renewers of thrift certificates, could constitute substantial assistance.<sup>375</sup> The district court applied the *Woodward-Monsen* exception to the rule that inaction can be the proper basis of liability if an independent duty to act or disclose exists. The exception requires: (1) proof that the aider and abettor had actual knowledge of the securities fraud; and (2) a high conscious intent to assist in the perpetration of that fraud by means of its silence and inaction.<sup>376</sup> Both the district court and the Eighth Circuit focused on the question of BTC's actual knowledge, "because without such knowledge BTC could not have had the high *conscious* intent required by the *Woodward-Monsen* test."<sup>377</sup> However, an examination of both decisions indicates that the courts blended the two independent requirements rather than isolating the question of BTC's actual knowledge and then addressing the issue of "high conscious intent to assist in the perpetration of the fraud."<sup>378</sup> Specifically, both courts focused on IEI's declining financial health, evidenced by the company's balance sheet. The Eighth Circuit speculated that BTC had actual knowledge of the existence and extent of the thrift certificate program by looking at IEI's assets-to-liabilities ratio and its borrowing ratio for February, 1972, and March, 1973.<sup>379</sup>

Furthermore, BTC's only activity with the IEI thrift certificates was in its role as escrow agent and its direct receipt of thrift certificate proceeds from IEI to make payments on the outstanding loans.<sup>380</sup> This constitutes only minor involvement, was plainly minis-

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374. *Landy*, 486 F.2d at 163. See note 297 and accompanying text *supra*.

375. See *Metge*, 577 F. Supp. at 820.

376. See *id.* at 821-22 (citing *Monsen*, 579 F.2d at 800; *Woodward*, 522 F.2d at 97) (the more ordinary the business transaction, the greater the knowledge requirement of scienter).

377. *Metge*, 577 F. Supp. at 822 (emphasis original).

378. *Id.*

379. See *Metge*, 762 F.2d at 628. The court noted: "As early as February 10, 1972, BTC concluded that, for fiscal 1971, IEI exhibited an assets-to-liabilities ratio of .236 to 1 (\$905,000 to \$3,840,400), and a borrowing ratio of 8.70 to 1, based on liabilities of \$10,933,900 and a capital structure of \$1,257,300. By March, 1973, IEI's assets-to-liabilities ratio had improved to 1.09 to 1, but its borrowing ratio had increased to 13.26 to 1." *Id.*

380. See *Metge*, 762 F.2d at 629.

terial, and could not constitute substantial assistance in the fraud.<sup>381</sup> Generally, a transfer agent or clearing agent is under no fiduciary duty to the owners of the securities that pass through its hands.<sup>382</sup> The alleged "substantial assistance" consisted of ordinary banking transactions intended to further legitimate goals of business. To label them as "substantial assistance" toward a securities violation would render banks and lenders strictly liable for their customers' activities.<sup>383</sup> The delay accompanying independent investigations by banks and lenders would unduly burden normal banking procedure without furthering legitimate investor protection. Although the court was not passing on the merits of the plaintiff's case, it was determining whether there were sufficient facts to preclude summary judgment.<sup>384</sup> When the knowledge element of the third prong of the *Coffey* test was dropped by the Eighth Circuit, it was able to find sufficient facts to impute substantial assistance by BTC.<sup>385</sup> Dropping the "knowledge" element from the third prong of the *Coffey* test expanded the scope of aider and abettor liability, thereby leading to the unfortunate conclusions made by the *Metge* court.

Even though BTC lost \$650,000 in principal and accrued interest as a result of IEI's insolvency, the court reasoned that BTC "benefited" from IEI's delayed bankruptcy.<sup>386</sup> The court indicated that this evidenced BTC's alleged "high conscious intent" by remaining silent and inactive.<sup>387</sup> The Eighth Circuit inferred that because BTC was able to reduce its initial exposure from \$950,000 to \$650,000, it remained silent to "lever itself in a more favorable position than the holders of thrift certificates."<sup>388</sup> This level of "conscious intent" approaches a negligence standard for inactivity. The court implies that BTC must or should have known that its silence was allowing BTC to lever itself into a "more favorable position."<sup>389</sup> Another possible inference could be that BTC hoped that IEI's position would rectify itself.<sup>390</sup> Furthermore, it is only natural that a lender's exposure on a

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381. See *Metge*, 577 F. Supp. at 821.

382. See *Woodward*, 522 F.2d at 97. The Fifth Circuit noted that Texas law imposes no fiduciary duty as to the owners of securities. *Id.*

383. See *Ruder, Multiple Defendants*, *supra* note 1, at 630.

384. *Metge*, 762 F.2d at 630.

385. *Id.*

386. *Id.* at 629.

387. *Id.*

388. *Id.* at 630.

389. *Id.*

390. *Cf. id.* at 625-30. BTC's President Robert J. Sterling said that the May, 1973, refinancing plan was intended "to keep all of this thing afloat." *Metge*, 762 F.2d at 627. The Eighth Circuit gave this statement no weight, but it was BTC's clear intention to support IEI rather than to turn its back on a customer which was in a precarious financial position. An old adage is appropriate here: When you owe a bank \$10,000 and

loan would be reduced over the life of the loan. Therefore, the Eighth Circuit inferred too much from BTC's silence.

Courts should consider silence and inactivity as sufficient intent only where the defendant aider and abettor owed the plaintiff a duty.<sup>391</sup> To impute aiding and abetting liability for silence and inactivity is dangerously over-inclusive and could ensnare innocent "deep pocket" businesses whose only fault may be unknowingly transacting business with a securities violator.<sup>392</sup>

## CONCLUSION

The Eighth Circuit's opinion in *Metge* sends a message to the banking industry to diligently investigate each of its customers who borrow money. Should any of their customers be defrauding the investing public, banks could be held strictly accountable. If evidence exists of an "unusually favorable banking relationship"<sup>393</sup> between the two parties, especially where the lender knows of its customer's precarious financial position, aiding and abetting liability under Rule 10b-5 could arise. The aiding and abetting elements, adopted by the Eighth Circuit in *Stokes* and applied in *Metge*, approach the negligence standard in Rule 10b-5 and section 10(b) violations which was explicitly rejected by the United States Supreme Court in *Ernst & Ernst*. For that purpose, it should be reinterpreted in light of *Ernst & Ernst* with particular attention given to the third element of the *Coffey* test. The *Metge* test is over-inclusive and could ensnare innocent "deep pocket" businesses without furthering legitimate interests of the investing public.

The court's interpretation and implementation of the controlling person provisions likewise seem to adopt a negligence standard. The two-part test utilized by the *Metge* court does not advance the legisla-

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cannot pay it, *you* are in trouble; when you owe a bank \$1,000,000 and cannot pay it, the *bank* is in trouble.

391. See note 315 and accompanying text *supra*. See also Peoples Nat'l Bank v. Nichols, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 92,284, at 91,953 (D. Or. July 10, 1985). After establishing the elements of a cause of action for aiding and abetting under § 10(b), the district court in *Nichols* noted that liability attaches only where the defendant owed a duty to disclose material facts to the claimant. *Id.* To determine the scope of that duty the court offered the following considerations: (1) the relationship of the defendant to the plaintiff; (2) the defendant's access to information compared to that of the plaintiff; (3) the benefit the defendant derived from the relationship; (4) the awareness by the defendant of the plaintiff's reliance on him or her; (5) the defendant's activity in initiating the securities transaction in question. *Id.* (citing *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808 (9th Cir. 1981)).

392. See *Woodward*, 522 F.2d at 97. The court stated that, "[w]ithout these limitations, the securities laws would become an amorphous snare for guilty and innocent alike." *Id.*

393. *Metge*, 762 F.2d at 630.

tive intent of the Securities Exchange Act of 1934. On the contrary, to impose strict liability on control persons violates the 1934 Act's legislative purpose while emasculating section 20(a). The more restrictive culpable participation requirement, unlike the *Metge* test, does not render the good faith and noninducement defenses mere surplusage, and consequently meaningless. To the extent that *Metge* violates this fundamental canon of statutory interpretation, the holding establishes poor precedent. The targets for secondary liability have been constantly broadened by the court system. The court's decision in *Metge* makes members of the banking industry virtually insurers of their customers who issue securities.

*Shaun P. Kenney — '86*

