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Securities Regulation -- Vicarious Liability For Securities Acts Violations -- By Common Law or By Statute?

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The North Carolina Court of Appeals indicated in *Harris* and *Brannon* that a concern for opening a trial to issues "collateral to that of guilt or innocence" of a defendant led it to adopt the rule against attacks on credibility.[61] If that was its concern, the court should consider a procedure such as the one followed in the Seventh Circuit, instead of adopting the absolute rule against attacks on credibility. In most cases, the court would accomplish its objective of avoiding a hearing on collateral issues. Few defendants would pass the initial showing obstacle, particularly in cases in which the court found no cause for requiring police officers to disclose the identity of their informants.[62] Meanwhile, the court would be following a procedure more in line with the constitutional policies put forth by *Mapp* by granting review of credibility in the most flagrant situations.

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Securities Regulation—Vicarious Liability For Securities Acts Violations—By Common Law or By Statute?

Congress regulated a variety of activities relating to the distribution and trading of securities in the Securities Act of 1933[1] and the Securities Exchange Act of 1934.[2] Each of these acts contains a provision whereby one in "control"[3] of an individual who violates the acts' provisions may also be held liable for the violation.[4] This liability, however,

61. The court indicated this when it said: "To permit a defendant to challenge the truth or accuracy of the factual averments of the affidavit, would open at trial an issue or issues, theretofore judicially determined, collateral to that of guilt or innocence." 25 N.C. App. at 406, 213 S.E.2d at 416.

62. One court has argued that the initial showing requirement would not cut down on the number of pretrial hearings. State v. Anonymous, 30 Conn. Supp. 211, —, 309 A.2d 135, 146 (1973). As long as the court required something more than mere allegations to constitute a "showing," however, it would seem the threshold obstacle would be a barrier to some and probably to most defendants.

1. 15 U.S.C. §§ 77a-aa (1970).

2. *Id.* §§ 78a-hh.

3. "Control" is an intentionally undefined term. The framers of the Securities Exchange Act commented on its meaning: "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." H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934).

4. Section 15 of the 1933 Act provides:

is made subject to the defense that the controlling person was ignorant of the violation or acted in "good faith."[5] The federal judiciary has occasionally faced the question whether the controlling persons provisions afford the exclusive means of imputing liability for violations of the 1933 and 1934 Acts to the violator's superiors, or whether vicarious liability can also be predicated upon common-law principles of *respondeat superior*[6] or agency.[7] Since common-law liability attaches regardless of the personal culpability of the master or principal, the issue is of considerable practical importance. A distinct split has emerged from those circuits in which the matter has been considered. In *Zweig v. Hearst Corp.*[8] the Ninth Circuit for the first time clearly held that common-law principles of vicarious liability have no application to actions brought under the 1934 Act.[9] As a consequence defendant Hearst Corporation was afforded an opportunity to exculpate itself by proving that it had "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation."[10]

> 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 (1970).

Section 20(a) of the 1934 Act provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1970).

5. See final clauses of sections quoted in note 4 *supra*.

6. See RESTATEMENT (SECOND) OF AGENCY §§ 250-67 (1954).

7. See *id.* §§ 219-49. While vicarious liability based on a master-servant relationship is distinct, both in terms of origin and effect, from that based on a principal-agent relationship, both will be referred to in terms of "agency." *See* Ferson, *Bases for Master's Liability and For Principal's Liability to Third Persons*, 4 VAND. L. REV. 260 (1951).

8. 521 F.2d 1129 (9th Cir. 1975).

9. The opinion in *Zweig* states that Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. denied*, 393 U.S. 801 (1968), provides controlling authority for the decision. The *Kamen* opinion is rather cryptic, however, and its ambiguity has been noted by both court and commentator. Jackson v. Bache & Co., 381 F. Supp. 71, 94 (N.D. Cal. 1974); Note, *Vicarious Liability For Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 716 (1974).

10. 15 U.S.C. § 78t(a) (1970). *See* note 4 *supra*.

Zweig v. Hearst Corp. resulted from the publication of a financial column by defendant Hearst Corporation (hereinafter Hearst). This column, authored by a longtime and apparently reliable employee of the paper, praised the virtues of a publicly-held corporation. Undisclosed was the fact that the columnist held some of the corporation's stock. Subsequent to the publication of this laudatory column, the price of the corporation's stock advanced dramatically. The financial writer disposed of some or all of his stock at this higher price. The value of the stock later declined. Suit was brought against both the columnist and Hearst by a number of persons who alleged financial injury as a consequence of the price fluctuation of the corporation's stock allegedly resulting from the newspaper story. Plaintiffs contended that the writer's failure to disclose his interest in the company constituted a violation of section 10(b) of the 1934 Act[11] and Securities and Exchange Commission Rule 10b-5 promulgated thereunder.[12] Vicarious liability was asserted against Hearst based upon the employment relationship. Hearst moved for summary judgment, which the district court granted. Plaintiffs appealed, arguing that Hearst should be held liable for the acts of its employee under an "agency theory of *respondeat superior*." The Ninth Circuit Court of Appeals rejected this contention, relying on its previous holding in *Kamen & Co. v. Paul H. Aschkar & Co.*[13] which it characterized as follows:

> *Kamen* appears to be the forerunner of a series of cases in the various circuits treating with the liability of an employer where an employee violates Section 10(b). It was there held that Section

11. 15 U.S.C. § 78j(b) (1970).

12. Securities and Exchange Commission Rule 10b-5, promulgated under authority of section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970) states:

> 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.

17 C.F.R. § 240.10b-5 (1975).

Beginning with Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), courts have recognized a private right of action for rule 10b-5 violations which result in investor injury. Recognition of such a right is now virtually universal, and has received the tacit endorsement of the Supreme Court. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). See 6 L. Loss, SECURITIES REGULATION 3870-73 (1969).

13. 382 F.2d 689 (9th Cir. 1967), *cert. denied*, 393 U.S. 801 (1968).

20(a), the controlling person provision, is to be applied to determine such liability. The contention that the more stringent doctrine of *respondeat superior* remained effective to establish vicarious liability was rejected.[14]

While the Ninth Circuit in *Kamen* and *Zweig* did not address arguments that the statutory provision preempts the common law theories of liability, the issue has been the subject of judicial disagreement in recent years. At least three circuits have concluded that vicarious liability for violations of the Securities Acts can be predicated on common law principles. Of these, the Fifth Circuit adopted *sub silentio* a non-exclusivity position, holding a brokerage firm liable for an employee's sale of unregistered securities on the basis of principles embodied in the Restatement of Agency.[15] The Seventh Circuit, in *Fey v. Walston & Co., Inc.*,[16] similarly rejected arguments that the controlling persons provision of the 1934 Act is exclusive, citing precedent that purportedly recognized "that the mere existence of remedial provisions in the Securities Acts does not foreclose the application of similar common law remedies . . . ."[17] The Fourth Circuit's stance, enunciated in *Johns Hopkins University v. Hutton*,[18] hinges the non-exlusivity of the controlling persons sections on congressional intent and public policy. The SEC has argued in favor of non-exclusivity for similar reasons.[19]

Cases in the Second and Ninth Circuits have reached contrary results. In *SEC v. Lum's, Inc.*[20] the District Court for the Southern District of New York determined that the controlling persons section of the 1934 Act afforded the sole means of imputing an employee's rule 10b-5 violation of his employer,[21] relying partly on the Second Circuit's decision in *Lanza v. Drexel & Co.*[22] It was determined in the latter case that the controlling persons provision provided the standard by which the vicarious liability of corporate directors was to be determined.

14. 521 F.2d at 1132.

15. Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973).

16. 493 F.2d 1036 (7th Cir. 1974).

17. *Id.* at 1052 n.18.

18. 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part, and remanded,* 422 F.2d 1124 (4th Cir. 1970). The district court's position on the exclusivity issue was adopted by the Fourth Circuit, however. See 422 F.2d at 1130.

19. Brief for SEC as amicus curiae at 13-14, 23, Paul H. Aschkar & Co. v. Kamen & Co., 390 U.S. 942 (1968), *cited in,* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. PA. L. REV. 597, at 606 n.37, 607 n.41 (1972) [hereinafter cited as SEC Brief].

20. 365 F. Supp. 1046 (S.D.N.Y. 1973).

21. *See* note 12 *supra.*

22. 479 F.2d 1277 (2d Cir. 1973).

Likewise, the Ninth Circuit's *Kamen* decision, recently clarified in *Zweig*, now stands for the proposition that the controlling persons section of the 1934 Act affords the exclusive basis for imputing liability for rule 10b-5 violations to the violator's employer.[23]

The facts in the *Lanza* and *Zweig* decisions are distinctive from those in other cases because neither involved the typical situation: vicarious liability asserted against a brokerage house for the Securities Acts violations of its employees. While such factual differences may contribute to the split in the circuits regarding the exclusivity question, an explicit and controlling basis of disagreement has been a differing perception of Congress's intent in enacting the controlling persons sections. In *Hopkins* the district court concluded: "What legislative history there is does not indicate that Congress intended Section 15 [of the 1933 Act], originally or as amended, to serve as a limitation on liability,"[24] while the Second Circuit, analyzing the history of the equivalent section of the 1934 Act, observed that:

> [t]he intent of Congress in adding this section, passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those directors . . . who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.[25]

Attempts to discern Congress's intent in enacting the controlling persons provisions seem unlikely to result in a definitive resolution of the exclusivity issue. No evidence that Securities Acts draftsmen considered the exclusivity question per se has come to light, and such a failure of congressional foresight seems quite plausible if one accepts Professor Ruder's arguments that Congress similarly failed to consider whether the Acts contained an implied private right of action for violations.[26] The history of the control sections themselves affords no clear insight into the purposes of Congress. Legislative reports indicate that the control provision of the 1933 Act was enacted to thwart

23. 382 F.2d at 697. See text accompanying note 13 *supra*.

24. 297 F. Supp. at 1211.

25. 479 F.2d at 1299.

26. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. Rev. 627 (1963). Professor Ruder's argument, if correct, supports the conclusion that Congress did not foresee the exclusivity question in two ways: it comments on the general inability of the Securities Acts draftsmen to foresee the reception their legislation would receive from the courts; it suggests that private actions under the Acts were contemplated as purely statutory creatures, the common law regarding vicarious liability having no more relevance thereto than would common law defining an appropriate period of limitation. *See also* note 12 *supra*.

securities violations by individuals operating through "dummies,"[27] and it may consequently be inferred that the controlling persons sections were intended to only govern vicarious liability outside the usual employment situation.[28] Yet, legislative reports also indicate that "agency" was one relationship that "control" was meant to embrace,[29] thereby giving rise to the inference that the control sections were intended to govern situations in which an employee acts as an employer's agent.

Furthermore, because the Acts were frankly-recognized compromises between the interests of the investing public and those of the business community,[30] any examination of congressional purpose behind their enactment is likely to be similarly unenlightening. References to the goals of the legislators in passing the Acts can therefore be used as a basis for arguing either side of the exclusivity question, depending on which aspects of legislative history a particular court chooses to emphasize. True effectuation of the purposes of the Securities Acts might better be attained through a balancing of interests of the sort suggested by the history and structure of the Acts themselves.

Brokerage houses seem most commonly to be the parties against whom vicarious liability is asserted in actions in which the exclusivity issue has been raised. Brokerage firms are subject to the rules of the SEC,[31] the various exchanges[32] and NASD.[33] Failure to comply with

27. H.R. REP. No. 152, 73d Cong., 1st Sess. 27 (1933).

28. Such was the position of the SEC in its brief. SEC Brief, *supra* note 19, at 14. *See* Note, 15 WM. & MARY L. REV., *supra* note 9, at 721-22.

29. H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934). The control section of the 1934 Act was apparently patterned after section 15 of the 1933 Act, and it may consequently be inferred that congressional purposes were similar. See Note, 15 WM. & MARY L. REV., *supra* note 9, at 721.

30. In a March, 1933 message to Congress, President Roosevelt stated: "The purpose of the legislation I seek is to protect the public with the least possible interference to honest business." S. REP. No. 47, 73d Cong., 1st Sess. 7 (1933), H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933). These dual purposes were also expressly recognized by members of Congress. See Ruder, *supra* note 26, at 648 & n.112. The balance between specifically permitted private actions, and the limitations which accompany each, further evidences that the Acts are compromises between opposing interests. See *id.* at 649-50.

31. 17 C.F.R. §§ 200.01-287.101 (1974).

32. Section 5 of the 1934 Act prohibits transactions on exchanges that are neither registered with the SEC nor exempted by the Commission from such registration. Registration involves the submission of exchange rules to the SEC. These rules must be "just and adequate to insure fair dealing and to protect investors . . . ." (15 U.S.C. § 78f(d) (1970)), and must include provisions for disciplining a member for "conduct or proceeding inconsistent with just and equitable principles of trade . . . ." *Id.* § 78f(b).

33. Rules of the National Association of Securities Dealers regulate transactions in over-the-counter markets. 15 U.S.C. § 78o-3 (1970).

these rules has been found to preclude the "good faith" defense,[34] and could serve as the basis of an independent suit.[35] Such firms, already required by regulation to supervise thoroughly[36] and hire carefully,[37] seem already forced to do all in their power to prevent employees' securities law violations. It is difficult to conceive of any further precautions that might be taken as a consequence of the imposition of strict liability for employees' misdeeds. Thus, with respect to this group of litigants, absolute liability for employees' securities law violations seems unlikely to serve any additional deterrence function.

While liability based on agency principles would not serve any further deterrence purposes with respect to securities dealers, such a liability standard would serve to guarantee to victims compensation for their financial loss. Compensation was apparently a goal of the Securities Acts.[38] In cases in which a brokerage house so demonstrated the adequacy of its supervision and care that a jury determined that the brokerage firm acted in "good faith," compensation might be denied the injured investor. In the *Hopkins* decision the district court stated:

> If Hutton, as the defendant in this case, is not liable . . . for the activities of . . . the manager of its oil and gas department, . . . then the partners in Hutton and in other brokerage houses like it can seemingly escape all liability under 12(2) by the simple expedient of making certain "not to know or have reasonable grounds

34. Fey v. Walston & Co., 493 F.2d 1036, 1051 (7th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973); Richardson v. MacArthur, 451 F.2d 35, 42 (10th Cir. 1971); Gordon v. Burr, 366 F. Supp. 156, 169 (S.D.N.Y. 1973); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973); Moerman v. Zipco, Inc., 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970).

35. *See* Hoblin, *A Stock Broker's Implied Liability To Its Customer For Violation of a Rule of a Registered Stock Exchange*, 39 FORDHAM L. REV. 253 (1970); Lowenfels, *Implied Liabilities Based on Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966); Lowenfels, *Private Enforcement In The Over-the-Counter Markets: Implied Liabilities Based On NASD Rules*, 51 CORNELL L. REV. 633 (1966); MacLean, *Brokers' Liability For Violation of Exchange and NASD Rules*, 47 DENV. L.J. 63 (1970); Note, *Federal Margin Requirements as a Basis For Civil Liability*, 66 COLUM. L. REV. 1462 (1966); Note, *Private Actions as a Remedy For Violations of Stock Exchange Rules*, 83 HARV. L. REV. 825 (1970).

36. See *e.g.*, New York Stock Exchange Rule 342, American Stock Exchange Rule 320.

37. See *e.g.*, New York Stock Exchange Rule 345, American Stock Exchange Rule 340 and comment .02 thereto.

38. Investor protection is a well-recognized purpose of the Acts. *See, e.g.*, Baird v. Franklin, 141 F.2d 238, 244-45 (2d Cir.) (Clark, J., dissenting in part), *cert. denied*, 323 U.S. 737 (1944), wherein Judge Clark pointed out thirty-six places where the 1934 Act refers to the goal of investor protection. That such protection entailed a right of compensation for injury has served as a basis for the implication of a private right of action under rule 10b-5. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

> to believe in the existence of the facts by reason of which the liability . . . is alleged to exist." Such a construction of Section 12 (2) and 15 would in effect mean that the partners in a brokerage house who kept their eyes and ears closed to the fraudulent conduct of one of their registered representatives, could reap the harvest of that employee's conduct with impunity. 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.[39]

While it is doubtful that brokerage firms could behave with such impunity, given the breadth of rule 10b-5 and prevailing interpretation of the good faith defense,[40] any protection of the firm's deeper pocket when its customers are injured by employees' misdeeds requires justification. Such justification might be found in the argument that the customer looks to a brokerage firm not as guarantor of its employees' honesty and capability, but as an organization that does all in its power to assure such honesty and capability through careful employee selection and supervision. When the firm fails to discharge these duties the customer's recovery should be against the firm. Careful selection and supervision is arguably all that the customer should expect of the firm, however, and when an employee nonetheless wrongfully injures an investor it is only to the employee that the customer should look for recovery.

This argument does not seem compelling when it is remembered that the firm profits from all business that its employees generate.[41] But decisions that seek to avoid such seeming inequity by hinging vicarious liability for securities laws violations on agency theories will require the application of agency principles in situations other than those involving a broker-client relationship—situations in which vicarious liability seems less appropriate. The potential liability that might attach to a general circulation newspaper because of its financial columnist's actions and recommendations is out of all proportion to the profits such a column could generate. Further, it seems clear that a newspaper is in a much poorer position to warrant the propriety of an employee's financial dealings and advice than is a brokerage house comprised of securities

39. 297 F. Supp. at 1212-13.

40. *See, e.g.*, Fey v. Walston & Co., Inc., 493 F.2d 1036, 1051 (7th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1301 (2d Cir. 1973); SEC v. Lum's Inc., 365 F. Supp. 1046, 1064 (S.D.N.Y. 1973); Moerman v. Zipco, 302 F. Supp. 439, 447 (E.D.N.Y. 1969).

41. Brokerage firms earn commissions which are roughly proportional to the volume of trading undertaken on behalf of their customers.

professionals. A financial columnist is a writer, not a broker or advisor. His advice no more carries the newspaper's warrant than does that of Ann Landers. It is the financial columnist himself, not the newspaper, to whom readers should look for responsibility for the propriety of analyses and recommendations. It therefore would be unfortunate if agency principles, under which the newspaper would be held vicariously liable as a consequence of the columnist's employment, should govern such a situation.

Virtual strict liability may be imposed on brokerage firms by reading the good faith defense to require extremely high supervisory standards over brokerage employees. But wholesale application of agency principles of vicarious liability to securities law violations would render the good faith defense a near nullity and remove from courts the ability to deny liability in circumstances such as those in the *Zweig* case. With the growth of securities litigation it seems likely that vicarious liability may be asserted against business enterprises that have an even less direct relationship with the securities field than that of the Hearst Corporation. Courts should continue to balance the interests embodied in the Securities Acts, and should permit employers to avail themselves of the exculpatory clauses of the Acts' controlling persons provisions.

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