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William J. Seiter

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Rule 10b-5 and Vicarious Liability Based on Respondeat Superior

It would be difficult to overstate the significance in federal securities law of the implied private right of action for damages under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. One issue arising under rule 10b-5 that the federal circuit courts have failed to resolve uniformly is whether an employer or other principal may be held vicariously liable for conduct of its employee or other agent that violates rule 10b-5 based on common law principles of respondeat superior or misrepresentation within the apparent authority of an agent. This issue arises most commonly in cases in which an investing customer seeks to hold a brokerage firm liable for securities fraud perpetrated by an employee of the firm. Two courts of appeals have held, and several commentators have argued, that section 20(a) of the Securities Exchange Act of 1934, which imposes liability on “controlling persons” of a primary wrongdoer, is the exclusive source of secondary liability for rule 10b-5 violations, thereby making common law agency principles inapplicable. Several other courts of appeals have ruled that section 20(a) does not preclude the application of agency principles, and that brokerage firms may be held vicariously liable for rule 10b-5 violations based on respondeat superior or apparent authority. The distinction between these two positions is crucial because section 20(a) allows the controlling person to assert a “good faith” defense which is unavailable under common law theories of vicarious liability.

This Comment argues that the position that section 20(a) excludes respondeat superior is insupportable. Rather, application of respondeat superior under rule 10b-5 is appropriate given the close nexus between the purposes underlying section 10(b) of the 1934 Act and the common law tort of deceit.

7. Since the cases that have held a brokerage firm vicariously liable for its employee’s rule
Part I briefly presents relevant background on the 1934 Act and respondeat superior. Part II outlines the case law development as to whether section 20(a) excludes common law agency as a source of secondary liability for rule 10b-5 violations. Part III argues that the exclusivity view is not supported by the language or legislative history of section 20(a), and that vicarious liability under section 10(b) may properly be imposed through the common law doctrine of respondeat superior.

I

RULE 10b-5 AND TWO TYPES OF SECONDARY LIABILITY

A. Rule 10b-5

Among the several antifraud provisions of the federal securities acts, the most general in scope is section 10(b) of the 1934 Act, which makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance" in contravention of rules and regulations which the Securities and Exchange Commission may prescribe. The SEC has promulgated more than a dozen rules under section 10(b), by far the most important of which is rule 10b-5, which provides that it is unlawful

(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 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.

An implied private right of action for damages under section 10(b) and rule 10b-5 was first held to exist in Kardon v. National Gypsum Co., and has since been explicitly approved by the Supreme Court as "well established."
B. Liability of Controlling Persons Under Section 20(a)

Section 20(a) of the 1934 Act provides that "[e]very person who, directly or indirectly, controls persons liable" under any section of the 1934 Act shall likewise be liable "unless the controlling person acted in good faith and did not directly or indirectly induce" the violation.\textsuperscript{14} The House Report indicates that the term "control" was left undefined in the 1934 Act because the representatives encountered difficulty in anticipating and enumerating the many ways in which control may be exercised.\textsuperscript{15} Also suggestive of the broad scope of the term "control" in section 20(a), is the controlling persons provision of the Securities Act of 1933, section 15,\textsuperscript{16} on which Congress patterned section 20(a). Section 15 specifically attempts to enumerate types of control, providing that "[e]very person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more persons by or through stock ownership, agency, or otherwise, controls any person liable" under sections 11 or 12 of the 1933 Act is likewise liable.\textsuperscript{17}

Numerous cases have held a brokerage firm to "control" its employee under section 20(a), making the firm liable for the employee's primary violation of rule 10b-5.\textsuperscript{18} A wide variety of other types of relationships has given rise to a determination of control for purposes of section 20(a).\textsuperscript{19}

\textsuperscript{14} 15 U.S.C. § 78t(a) (1976).
\textsuperscript{15} H.R. REP. No. 1383, 73d Cong., 1st Sess. 26 (1934). The report listed stock ownership, lease, contract, and agency as examples of different methods of control. \textit{Id}.
\textsuperscript{17} \textit{Id.} Section 15 as originally enacted contained no defense. H.R. REP. No. 152, 73d Cong., 1st Sess. 26 (1933). However, when the 1934 Act was enacted, an amendment to section 15 provided that a controlling person would be liable "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist." Pub. L. No. 73-291, 48 Stat. 908 (1934).

Though the term "control" in section 20(a) is broad enough to comprehend employment relations, it does not appear that Congress designed the section with employers in mind. Section 15 of the 1933 Act was born of a concern that corporate directors might attempt to evade liability under the registration provisions of section 11 by utilizing "dummy" directors to act in their stead, S. REP. No. 47, 73d Cong., 1st Sess. 5 (1933); H.R. CONF. REP. No. 152, 73d Cong., 1st Sess. 27 (1933). Similarly, the purpose of section 20(a) was to prevent evasion of the provisions of the 1934 Act "by organizing dummies who will undertake the actual things forbidden." Hearings before the Senate Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), 73d Cong., 1st Sess., pt. 15, at 6571 (1934), and section 20(a) seemed "to apply more particularly to corporations and officers, directors, and shareholders of corporations, than to exchanges or brokers." \textit{Id.} at 6639.

\textsuperscript{19} A good illustration of nonemployer control under section 20(a) is Malik v. Universal Resources Corp., 425 F. Supp. 350 (S.D. Cal. 1976), where the secretary-treasurer of a closely-held corporation who was an active director and substantial investor was held liable as a controlling...
A controlling person may nevertheless avoid liability under section 20(a) by showing that he "acted in good faith and did not directly or indirectly induce" the securities act violation. Every court that has considered the section 20(a) liability of a brokerage firm for its employee's rule 10b-5 violation has ruled that to show "good faith," the firm must show that it maintained and enforced a reasonable and proper system of supervision and internal control over the controlled employees to prevent securities acts violations. The courts are less demanding of nonbroker controlling persons, who generally may meet the good faith defense by showing they neither knew nor had reason to know of any violations.

C. Liability Based on Respondeat Superior

The common law doctrine of respondeat superior imposes liability irrespective of personal fault. This strict liability contrasts with the secondary liability imposed by section 20(a), under which nonculpable controlling persons may avoid liability by invoking the good faith defense.

Respondeat superior subjects a master to liability for the torts committed by his servants while acting within the scope of their employment. A servant is traditionally defined as one employed by another to perform services and whose physical conduct in performing the services is controlled, or subject to a right of control, by the other.

Cf. SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975) (a corporation controlled its vice-president in charge of trading); SEC v. First Sec. Co., 463 F.2d 891 (7th Cir.), cert. denied, 409 U.S. 880 (1972) (holding that a brokerage firm controlled the individual who was its president and owner of 92% of its stock); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971) (an insurance company controlled its agents); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (the intended beneficiary of a securities purchase controlled the purchaser who acted on his behalf); Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), aff'd per curiam, 422 F.2d 871 (2d Cir. 1970) (the directors of a corporation controlled its president).

21. See, e.g., cases cited at note 18 supra.
22. For instance, in Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973), the court of appeals declined to hold an outside director liable for the rule 10b-5 fraud perpetrated by other officials in the corporation, indicating that the good faith defense is met by persons who neither know nor reason to know of the fraud, but that the defense would fail if the fraud went unnoticed because of willful or reckless disregard. Id. at 1300-04, 1306. And in Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), aff'd per curiam, 422 F.2d 871 (2d Cir. 1970), although the directors of a corporation were held to "control" its president, they prevailed on their good faith defense because "the degree of control the defendants were able to exercise . . . was not similar to an employer-employee or an agent-principal relationship . . . . Directors cannot be expected to exercise the kind of supervision over a corporation president that brokers must exercise over salesmen." 302 F. Supp. at 447.
Conduct of a servant is "within the scope of employment" if it is of the kind he is employed to perform, occurs substantially within the authorized time and space limits of the employment, and is at least partly motivated by a purpose to serve the master. Although early decisions refused to hold an employer liable for a servant's intentional or "willful" wrongdoing, the modern tendency is to extend the employer's responsibility to such conduct, because even intentional torts may be so reasonably connected with the employment as to be within its scope. Thus, the respondeat superior doctrine may result in vicarious liability of an employer for fraud committed by an employee.

II

TWO VIEWS OF THE RELATION BETWEEN SECTION 20(a) AND COMMON LAW AGENCY

Two contrary positions have developed in the cases on the issue of whether vicarious liability for rule 10b-5 violations may properly be imposed based on common law theories of respondeat superior or misrepresentation within apparent authority. This Part examines the case authority that most clearly represents the two positions. The Ninth and Third Circuits have adopted the view that section 20(a) excludes common law agency as a source of secondary liability for rule 10b-5 violations. More recently, the Second and Fifth Circuits have held that section 20(a) does not exclude agency principles, and that employers may be vicariously liable based on respondeat superior for conduct of employees that violates rule 10b-5.

A. The Exclusivity View of Section 20(a)

1. The Ninth Circuit

The Court of Appeals for the Ninth Circuit adopted the exclusivity view of section 20(a) in Zweig v. Hearst Corp. In Zweig, the author of

25. RESTATEMENT (SECOND) OF AGENCY § 228 (1958).

Another source of liability without personal fault for employee fraud is the common law rule subjecting a principal to liability for loss caused by another's reliance on a tortious representation of its agent if the representation is apparently authorized. RESTATEMENT (SECOND) OF AGENCY § 257 (1958). "A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud." Id. § 261. The principal may be liable "although he is entirely innocent, has received no benefit from the transaction, and . . . although the agent acted solely for his own purposes." Id. § 261, comment a, at 570-71.

28. See cases cited at note 3 supra.
29. See cases cited at note 6 supra.
a daily financial column in a Hearst newspaper wrote a column highly favorable towards a certain publicly held company without revealing that he had recently invested in its stock. The price of the stock rose dramatically in response to the column, the author disposed of his holdings, and the price later fell off. Alleging damage from the price fluctuations, the plaintiffs contended that the author's conduct violated rule 10b-5 and that Hearst was vicariously liable as the author's employer. The court of appeals affirmed a summary judgment for Hearst, holding that it had met the good faith defense of section 20(a) as a matter of law and could not be held vicariously liable under the doctrine of respondeat superior. The court suggested that to meet the section 20(a) defense, a newspaper publisher should not be held to the strict standard of supervision that is generally required of broker-dealers, but that rather "[s]ome lesser standard amounting more nearly to culpability is indicated."\(^3\) The court avoided considering arguments over the exclusivity of section 20(a) by interpreting its earlier decision in *Kamen & Co. v. Paul H. Aschkar & Co.*\(^3\) as having rejected respondeat superior as a basis for liability under the securities acts, and concluded that "Kamen provides the controlling authority on this appeal."\(^3\)

But *Kamen* did not explicitly discuss the issue of rule 10b-5 liability based on respondeat superior or apparent authority. The plaintiff in *Kamen*, a broker-dealer victimized by an elaborate stock fraud scheme perpetrated by two employees of another broker-dealer, sued their employer under both the securities acts and the common law of deceit. The district court held that the employer firm was not liable under the controlling persons provisions—section 20(a) of the 1934 Act and section 15 of the 1933 Act—but that it was liable on the state common law claim because the two wrongdoers had acted within their ostensible authority in defrauding the plaintiff. The court of appeals reversed, holding that the district court finding of ostensible authority was "clearly erroneous."\(^3\) The court disposed of the securities acts claims without addressing whether common law agency principles were applicable under the acts, simply noting that the employer brokerage firm was not liable under the controlling persons provisions.\(^3\)

The Ninth Circuit reiterated the exclusivity view in *Christoffel v. E.F. Hutton & Co.*\(^3\) involving an action against a brokerage firm for losses sustained by the estate of an incompetent when the firm's ac-

31. *Id.* at 1135.
32. 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968).
33. 521 F.2d at 1132.
34. 382 F.2d at 694.
35. *Id.* at 697.
36. 588 F.2d 665 (9th Cir. 1978).
count executive dissipated and misappropriated assets of the estate during his tenure as guardian.\textsuperscript{37} Citing Zweig and Kamen, the court of appeals affirmed a summary judgment for the brokerage firm, merely asserting that "it is the established law of this circuit that section 20(a) supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine."\textsuperscript{38} Thus, the exclusivity view of section 20(a) is firmly entrenched in the law of the Ninth Circuit, yet the Court of Appeals for the Ninth Circuit has never discussed any reasoning for or against that view.

2. The Third Circuit

The Court of Appeals for the Third Circuit accepted the exclusivity view in Rochez Bros., Inc. v. Rhoades,\textsuperscript{39} a case involving a buy-sell agreement for stock of a closely held corporation between two of its officers. The president, already a fifty percent shareholder, purchased the remaining outstanding stock in the corporation from the executive vice-president without disclosing his recent meetings with two prospective buyers interested in the corporation. Eight months later the president sold all of the stock to a third prospective buyer at an enormous profit. The vice-president sued both the president and the corporation itself, and a judgment against the president for violation of rule 10b-5 was affirmed.\textsuperscript{40} The court of appeals affirmed a judgment on remand in favor of the corporation,\textsuperscript{41} ruling that the corporation could not be held liable under section 20(a) for its president's fraud,\textsuperscript{42} and furthermore that "the principles of agency, i.e., respondeat superior, are inappropriate to impose secondary liability in a securities violation case."\textsuperscript{43} The court argued that by including a good faith defense in section 20(a), Congress intended that liability thereunder be based not only on control but also on "culpable participation," and that applying respondeat superior would bypass this good faith defense. The court concluded that the latter outcome would not advance the legislative purpose of the 1934 Act, but rather would emasculate section 20(a).\textsuperscript{44}

However, the court's discussion suggests that it was seriously mis-

\textsuperscript{37} For purposes of summary judgment, the parties assumed that the account executive's conduct as guardian violated the securities laws. \textit{Id.} at 668.
\textsuperscript{38} \textit{Id.} at 667.
\textsuperscript{39} 527 F.2d 880 (3d Cir. 1975).
\textsuperscript{40} Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974).
\textsuperscript{42} 527 F.2d at 891.
\textsuperscript{43} \textit{Id.} at 884.
\textsuperscript{44} \textit{Id.} at 885. The court also relied on the Ninth Circuit decision in Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), \textit{cert. dismissed}, 393 U.S. 801 (1968), as authority. 527 F.2d at 885.
taken as to the potential reach of the respondeat superior doctrine. An employer is liable only for torts committed by its employees in the scope of their employment.\textsuperscript{45} Rochez expressly approved the district court finding that "any wrongdoing of defendant Rhoades was on his own account as a stockholder and individual and not in the course or scope of his employment by the said corporate defendant . . . or for the account or benefit of said corporate defendant . . . ."\textsuperscript{46} Thus, respondeat superior, if applied, would not have subjected the corporation to liability on the facts.\textsuperscript{47} So although Rochez established the exclusivity view of section 20(a) in the Third Circuit, the court's rejection of respondeat superior in rule 10b-5 cases seems to have been motivated by a mistake as to the reach of the doctrine.\textsuperscript{48}

**B. The Compatibility View of Section 20(a)**

1. The Second Circuit

In Marbury Management, Inc. v. Kohn,\textsuperscript{49} the Court of Appeals for the Second Circuit recently approved respondeat superior as a source of secondary liability in rule 10b-5 damages actions. Marbury Management and an individual investor purchased and retained as investments several securities on the recommendation of a brokerage firm employee who had represented to them that he was a lawfully registered representative and who had repeatedly stated that he was a stock

\textsuperscript{45} See note 23 and accompanying text supra.

\textsuperscript{46} 527 F.2d at 883 n.2.

\textsuperscript{47} The court apparently failed to appreciate the scope of employment requirement: "If we were to apply respondeat superior as appellant wishes, we would in essence impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they are dealing with their own corporate stock as individuals, and not for the corporation . . . ." \textit{Id.} at 885. The court stated mistakenly that respondeat superior imposes liability "on a mere showing of a principal-agent relationship." \textit{Id.}


Rochez closed its discussion of respondeat superior with a remark, the significance of which is unclear: "We are not faced with the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist. This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers. We can find no reason to impose this same duty in a situation like the one presently before us . . . ." 527 F.2d at 886. The district court in Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978), has construed this remark as expressly limiting the Rochez holding and suggesting that "in this circuit broker-dealers are liable under normal agency principles for violations of securities laws by their employees in the course of their employment . . . ." \textit{Id.} at 890. Sharp then argued that an accounting firm could be held liable based on respondeat superior for its employee's rule 10b-5 violation, since the roles of accounting firms "in securities transactions resemble more closely those of broker-dealers than those of corporations generally." \textit{Id.} at 891. This narrow reading of the Rochez holding would allow respondeat superior liability in virtually every rule 10b-5 case in which the employer is capable of active supervision over those employees acting within the scope of their duties.

\textsuperscript{49} 629 F.2d 705 (2d Cir.), cert. denied, 101 S. Ct. 566 (1980).
broader...broker. After dealing with him for two and a half years, the purchasers discovered that the employee was merely a trainee who was only qualified to accept buy and sell orders under the supervision of a broker and who was not qualified to recommend purchase of a security outside the brokerage office. The purchasers sued the trainee and his firm under rule 10b-5 for losses incurred on the securities transactions. The district court found that the trainee's misrepresentation about his status violated rule 10b-5, but dismissed at trial the claim against the firm because it concluded that the firm had not aided and abetted the trainee's fraud, since "the evidence supported neither a finding of conscious wrongful participation by the firm nor a legally equivalent recklessness but at best a finding of negligence in supervision." The court of appeals affirmed the judgment against the trainee and held that the district court erred in not considering whether the firm might be liable either under section 20(a) or based on respondeat superior.

The court noted that prior to Marbury it had avoided explicit resolution of the "rather thorny" issue of the exclusivity of section 20(a). SEC v. Management Dynamics, Inc. had concluded from the legislative history of section 20(a) that the section was not intended to supplant agency principles in securities cases and was enacted to expand rather than restrict the scope of liability under the 1934 Act. But Management Dynamics affirmed an injunction in an SEC enforcement action against a brokerage firm based on the apparent authority of an executive officer and intimated no view as to other potential cases involving lesser employees, actions for damages, or respondeat superior. Marbury concluded 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." Therefore, the court granted a new trial and held that the brokerage firm could be liable either under section 20(a), if it failed to meet the good faith defense by proving maintenance and enforcement of a reasonable system of supervision, or under the common law doctrine of respondeat superior, if the court considered the trainee's acts to have been within the scope of his employment.

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51. 629 F.2d at 707.
52. Id. at 712 (quoting Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 48 n.19 (2d Cir.), cert. denied, 439 U.S. 1039 (1978)).
53. 515 F.2d 801 (2d Cir. 1975).
54. Id. at 813.
55. 629 F.2d at 716.
56. Id.
2. The Fifth Circuit

In the most recent case to consider the exclusivity issue, Paul F. Newton & Co. v. Texas Commerce Bank, the Court of Appeals for the Fifth Circuit decided that section 20(a) does not exclude agency principles and that an employer may be vicariously liable through respondeat superior for conduct of its employee that violates rule 10b-5. Newton involved an elaborate fraudulent scheme to inflate the price of stock in an investment company traded in the over-the-counter market. A registered representative employed by the brokerage firm of Pressman, Frohlich & Frost, Inc. agreed in return for guaranteed profits to act in the scheme as a market maker for the stock, increasing with each transaction the price he quoted to buying brokers seeking to trade in the stock. One such buying broker, Paul F. Newton & Co., received purchase orders from several persons involved in the scheme who arranged to pay upon delivery of the stock certificates. Newton paid over large amounts for the stock to various market makers, including Pressman, before it discovered that the fake buyers were not going to pay for the stock. When the price of the stock collapsed after discovery of the scheme, Newton went into bankruptcy. Newton sued Pressman, seeking to impose liability for the acts of its employee in the price manipulation scheme based on respondeat superior and section 20(a). The district court granted a directed verdict for Pressman, ruling that respondeat superior could not be used to establish liability for violations of the 1934 Act and that Pressman could not be held liable under section 20(a) because it had not participated in or had knowledge of the employee's fraud.

The court of appeals reversed the directed verdict for Pressman, holding that common law agency principles, including respondeat superior, are a viable source of secondary liability under the 1934 Act and that as a matter of law Pressman failed to establish the good faith defense of section 20(a). The court reasoned that the legislative history of the controlling persons provisions reflects a concern with the specific problem of persons seeking to evade securities act liability by organizing "dummies" that under their control would commit the violations. The court concluded that the legislative history did not reflect any congressional intent to restrict secondary liability. "Limiting secondary liability under the 1934 Act to that liability provided by section 20(a) would contradict the pervasive application of agency principles in nearly all other areas of the law." Therefore, the court concluded

57. 630 F.2d 1111 (5th Cir. 1980).
58. Id. at 1118. The court remanded the case for a new trial on the issues of whether the employee acted within the scope of his employment in the scheme and whether Pressman had diligently enforced a proper system of supervision and control. Id.
of the recognized connection between section 10(b) and the common law action of deceit.

A. The Nonexclusivity of Section 20(a)

Recent Supreme Court decisions interpreting the federal securities laws, including several significant opinions narrowing the substantive scope of section 10(b), emphasize the importance of statutory language and structure in discerning congressional intent.62 These cases suggest that resolution of the issue of whether Congress intended section 20(a) to exclude common law agency principles should commence with examination of the language, structure, and legislative history of section 20(a). However, inquiry into the language and history of section 20(a) may not prove conclusive.63

Section 20(a) provides that “[e]very person who, directly or indirectly, controls persons liable” under any section of the 1934 Act shall be likewise liable “unless the controlling person acted in good faith and did not directly or indirectly induce” the violation.64 Control for purposes of section 20(a) may be predicated on a principal-agent relation,65 but the section makes no explicit mention of agency, the employment relation, respondeat superior, apparent authority, or the common law. Thus, section 20(a) does not on its face reveal any congressional attitude toward common law agency as a source of secondary liability in connection with violations of the 1934 Act.

Several cases and commentators have used the legislative history of section 20(a) in attempting to demonstrate a congressional intent to exclude agency principles. The arguments hinge on the legislative history of the controlling persons provision of section 15 of the 1933 Act, on which Congress modeled section 20(a). In drafting versions of section 11 of the 1933 Act,66 the Senate and House differed on the desira-

63. As the Supreme Court pointed out in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, for instance, though the implication of a private right of action under rule 10b-5 may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.
Id. at 737. This approach may be relevant in the interpretation of section 20(a) as well, particularly as it interacts with rule 10b-5.
65. See notes 18-20 and accompanying text supra.
that Pressman could be held liable via respondeat superior for its employee's rule 10b-5 violation.

C. The Split on the Exclusivity Issue

To summarize, the case authorities are divided on the issue of whether vicarious liability for rule 10b-5 violations based on respondeat superior is proper. The Ninth and Third Circuit Courts of Appeals accept the view that section 20(a) excludes respondeat superior. But the Ninth Circuit Court of Appeals has never discussed any reasoning for or against its position, and the Third Circuit Court of Appeals seems to have been mistaken as to the proper application of respondeat superior when it adopted the exclusivity view. In contrast, the Second and Fifth Circuit Courts of Appeals have taken the opposite position that section 20(a) does not exclude respondeat superior and have held that brokerage firms may be vicariously liable through respondeat superior for their employees' violations of rule 10b-5. From the conclusion that section 20(a) does not preclude other possible sources of secondary liability, the Second and Fifth Circuit Courts of Appeals both automatically assumed that respondeat superior ought to apply under rule 10b-5 given "the pervasive application of agency principles in nearly all other areas of the law." Part III below suggests that although the position of the Second and Fifth Circuits is the better one, a closer inquiry should be made into the appropriateness under section 10(b) and rule 10b-5 of respondeat superior liability.

III

The Applicability of Respondeat Superior Under Section 10(b)

This Part argues that vicarious liability for rule 10b-5 violations may properly be imposed based on the common law doctrine of respondeat superior. The argument is presented in two steps. Subpart A argues that neither the language nor legislative history of section 20(a) supports the position that the provision excludes common law principles of secondary liability from application under the 1934 Act. From this, it does not immediately follow that applying respondeat superior under rule 10b-5 is correct, but only that section 20(a) does not foreclose the possibility of such applications. Subpart B argues that respondeat superior liability under rule 10b-5 is especially appropriate in light

59. See notes 32-38 and accompanying text supra.
60. See notes 45-48 and accompanying text supra.
bility of imposing liability without fault for false statements made in registration statements required in connection with new issues of securities, and the conference committee adopted the House version, which imposed a duty of reasonable care to assure the accuracy of registration statements. "In order to aid in preventing directors from evading the liabilities incident to signing the registration statement through the fraudulent use of "dummy" signers of registration statements, the original Senate version of the 1933 Act contained provisions governing so-called "dummy" directors. The legislation was "calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised . . ." The dummy provisions became the basis for section 15, which as originally enacted provided that "[e]very person who, by or through stock ownership, agency, or otherwise, or who pursuant to or in connection with an agreement with one or more persons by or through stock ownership, agency, or otherwise controls any person liable" under sections 11 or 12 of the 1933 Act is likewise liable. When the 1934 Act, including section 20(a) in its present form, was enacted, Congress also amended section 15 of the 1933 Act to provide a defense analogous to the good faith defense of section 20(a). Given their closely intertwined legislative history, the courts have generally given the two sections like interpretations.

One argument advanced for the exclusivity view is that the specific use of the word "agency" in section 15 indicates that Congress intended

67. The conference committee explained:

A point of difference . . . concerned the civil liability of persons responsible for the flotation of an issue. The Senate amendment imposed upon the issuer, its directors, its chief executive and financial officers, a liability which might be appropriately denominated an insurer's liability. They were held liable without regard to whatever care they may have used for the accuracy of statements made in the registration statement. The House bill, on the other land, measured liability for these statements in terms of reasonable care.

. . . .

Though the standards of the Senate amendment were more severe than those embodied in the House bill, the classes of persons upon whom liability was imposed were less. The House bill imposed liability upon the underwriters and also upon the experts, such as accountants, appraisers, and engineers, who gave the authority of their name to statements made in the registration statement.


68. Id.


73. E.g., Pharo v. Smith, 621 F.2d 656, 673-74 (5th Cir. 1980).
it to supplant common law agency principles of secondary liability.\textsuperscript{74} Since the House report on section 20(a) also mentions "agency,"\textsuperscript{75} it is argued that both controlling persons provisions should exclude the application of respondeat superior under the securities acts.

This argument is unconvincing in several respects. Since section 15 as originally enacted provided no affirmative defense for controlling persons, the original inclusion of the term "agency" surely must not have been designed to restrict the liability of employers and other principals for section 11 and 12 violations. Nor does the retention of the term "agency" in amended section 15 and its mention in the House report on section 20(a) plausibly suggest a deliberate decision by Congress to exclude common law agency principles. It is improbable that Congress intended the bare term "agency" as an allusion to the doctrine of respondeat superior, which applies not to all principal-agent relations but only to employer-employee relations under limited circumstances. The inconspicuous embedding of the word "agency" in the lists of control methods in section 15 and the House report on section 20(a) further casts doubt on the argument that it indicates congressional intent to exclude respondeat superior.

Another argument for the exclusivity view is that since section 15 originally imposed strict liability but was amended to provide a defense, the amendment shows that Congress rejected liability without fault.\textsuperscript{76} And since section 20(a) similarly contains a good faith defense, it also constitutes a rejection of strict liability. Therefore, it is argued, courts that have held employers strictly liable under respondeat superior for securities act violations have acted contrary to the intent of Congress.

This interpretation of the section 15 and 20(a) defenses as rejections of respondeat superior liability is unconvincing once one considers the congressional purpose behind making controlling persons liable. "Section 15 had its genesis in the concern that directors would attempt

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\textsuperscript{75} See note 15 and accompanying text \textit{supra}.
\textsuperscript{76} Fischel, \textit{supra} note 4, at 98-99.

Professor Fischel states that "the original version of section 15 raised numerous complaints from the business community, which felt it was 'too drastic, and interfered with business,'" \textit{Id.} at 98 n.105 (quoting Senator Fletcher, 78 \textit{CONG. REC.} 8668 (1934) (remarks of Senator Fletcher)). However, Senator Fletcher's remarks were addressed not to section 15 in particular but to the 1933 Act as a whole and were made in connection with a number of significant amendments to the act. \textit{Id}. Those remarks therefore reveal nothing about congressional intent as to the controlling persons provisions. The sole comment in the legislative history concerning the amendment of section 15 is a conference report statement that it was "to restrict the scope of the section so as to more accurately carry out its real purpose," H.R. REP. NO. 1838, 73d Cong., 2d Sess. 42 (1934). This statement also fails to uncover the particular aim of the amendment as to controlling persons.
to evade liability under the registration provisions by utilizing ‘dummy’
directors to act in their stead." And section 20(a) had "the identical
purpose of preventing persons from avoiding liability under the provi-
sions of the Securities Exchange Act by utilizing ‘dummies’ to commit
the prohibited acts." Thus, the defenses contained in each section
represent a congressional judgment that directors, officers, and major
shareholders who control securities act violators should not be held
strictly liable. But nothing in the legislative history indicates that Con-
gress contemplated employers, much less the common law doctrine of
respondeat superior, when it drafted defenses to section 15 and 20(a)
liability. Therefore, the availability of those defenses does not imply
that Congress rejected the possibility that, at least under some provi-
sions of the securities acts, liability without fault might be imposed
through respondeat superior. This Comment will argue below that re-
spondeat superior liability for employers is perfectly compatible with
allowing defenses for other kinds of controlling persons.

B. The Appropriateness of Respondeat Superior Under Section 10(b)

I. Section 10(b) and Common Law Deceit

The language of section 10(b), which makes unlawful the use of
"any manipulative or deceptive device or contrivance," indicates that
Congress enacted it largely in response to perceived inadequacies of the
common law tort action of deceit as a means of dealing with securities
fraud. Professor Loss has discussed the relationship between com-
mon law deceit and the antifraud provisions of the securities acts, ob-
serving that because "[s]tatutes build on the common law," the
common law naturally provides guidance in statutory interpretation.
Loss notes that the language of the antifraud provisions makes it obvi-
ous that some of the basic substantive questions are the same as in com-
mon law deceit actions. Thus, in interpreting the substantive scope of
section 10(b) and rule 10b-5, the courts have often turned to the com-
mon law of deceit for guidance, generally reading section 10(b) to be at

78. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1115-16 (5th Cir. 1980).
80. And one reason for the promulgation of rule 10b-5 was that the common law did not
adequately protect investors. 1 A. Jacobs, The Impact of Rule 10b-5, at 5 (1980). The very
sparse legislative history surrounding the enactment of section 10(b) furnishes practically no evi-
dence pertaining to congressional intent. 1 A. Bromberg, supra note 8, § 2.2 (330-40). This fact
enhances the significance of the statement of purpose contained in section 10(b) itself, that rules
promulgated thereunder are to be "for the protection of investors." 15 U.S.C. § 78j(b) (1976).
81. L. Loss, supra note 8, at 1430-42.
82. Id. at 1435. Because of the similarity in language, Loss further believes it "reasonable to
assume at the very least that the most liberal common law view on these questions should govern
under the statutes." Id.
least as generous in protecting defrauded plaintiffs as the common law.\textsuperscript{3} This interpretive strategy is a credible attempt to track probable congressional intent, given the exceptionally sparse formal legislative history on section 10(b).\textsuperscript{4} The authority that Congress gave the SEC to prescribe rules and regulations under section 10(b) that are "necessary or appropriate in the public interest or for the protection of investors"\textsuperscript{5} indicates that Congress regarded common law deceit as insufficiently protective of securities investors. Moreover, nothing in the 1934 Act or its legislative history suggests that Congress thought the common law to be overprotective in any respect.\textsuperscript{6} Therefore, courts should be reluctant to construe section 10(b) as less generous than the common law.

The Supreme Court's approach in \textit{Blue Chip Stamps v. Manor Drug Stores}\textsuperscript{87} is especially instructive. In that case the Court upheld the Birnbaum rule which requires that rule 10b-5 plaintiffs must have purchased or sold a security.\textsuperscript{88} This requirement gives section 10(b) a narrower scope than common law deceit:

In considering the policy underlying the Birnbaum rule, it is not inappropriate to advert briefly to the tort of misrepresentation and deceit, to which a claim under § 10b-5 certainly has some relationship. . . . [I]t has long been established in the ordinary case of deceit that a misrepresentation which leads to a refusal to purchase or to sell is actionable just the same way as a representation which leads to the consummation of a purchase or sale. . . .

But the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable. . . . Although the claim to damages [in a common law deceit action cited by the Court] was based on an allegedly fraudulently induced decision not to put the [plaintiff's patented cotton baling] machines on the market, the plaintiff and the defendant had concededly been engaged in the course of business dealings with one another, and would presumably have recognized one another on the street had they met.

\textsuperscript{83} E.g., Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). Investors are further benefited because "the courts have repeatedly said that the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit." L. Loss, supra note 8, at 1435.
\textsuperscript{84} See note 80 supra.
\textsuperscript{86} The general posture of Congress toward the common law is indicated by section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1976), which specifies that the rights and remedies provided by the 1934 Act shall be in addition to any and all rights and remedies that may exist at common law or in equity. This implies that Congress regarded common law rights and remedies as overly restrictive in certain respects but not as overly liberal.
\textsuperscript{87} 421 U.S. 723 (1975).
In today's universe of transactions governed by the 1934 Act privi-

lity of dealing or even personal contact between potential defendant and

potential plaintiff is the exception and not the rule.89

Significantly, the Court felt it necessary to explain its giving sec-

tion 10(b) a narrower substantive scope than common law deceit by

arguing that the common law rule, which does not require purchase of

stock, is peculiarly inappropriate in the context of securities trading. This

suggests that courts should hesitate to interpret section 10(b) and

rule 10b-5 more narrowly than common law deceit unless the express

language of section 10(b) so dictates or the particular common law rule

is unsuitable as applied to securities fraud.

The judicial strategy of deference to the common law of deceit in

interpreting the substantive scope of section 10(b) raises the question of

whether it is similarly appropriate to determine the scope of secondary

liability under section 10(b) through reference to secondary liability for

deceit at common law. Professor Fischel argues against any form of

secondary liability for section 10(b) violations aside from that explicitly

imposed on controlling persons in section 20(a), because although sec-
tion 10(b) makes unlawful the use of manipulative or deceptive prac-
tices, it does not expressly make it unlawful to employ, aid and abet, or

conspire with a person who violates the section.90 Fischel construes the

failure of section 10(b) to impose any explicit form of secondary liabil-

ity to mean that Congress did not intend to impose liability upon con-
duct that would not otherwise be prohibited as a manipulative or
deceptive practice. But Fischel's argument places undue stress on the
silence of section 10(b). The Supreme Court cases on which he relies do
emphasize the need to "turn first to the language of § 10(b)," since
"[t]he starting point in every case involving construction of a statute is
the language itself."91 But each of the cases interpreted actual language
contained in section 10(b).92 The issue of whether respondeat superior
ought to apply under rule 10b-5 is not resolved by turning to the lan-
guage of section 10(b), because that section includes no language per-
taining to vicarious liability.

Fischel's approach to statutory interpretation is too mechanical to

89. 421 U.S. at 744-45.

90. Fischel, supra note 4, at 94-95.


92. For instance, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, interpreted the phrase, "in connection with the purchase or sale of any security," to disallow an action by offerees of an allegedly misleading stock offering who had not purchased or sold any of the offering shares. And Ernst & Ernst v. Hochfelder, 425 U.S. 185, interpreted the words, "manipulative or deceptive device or contrivance," to require scienter, so that an accounting firm alleged to have aided and abetted securities fraud through negligent nonfeasance could not be held liable under rule 10b-5.
be workable. For instance, it implies that because section 10(b) is utterly silent on the subject of actions for damages, an implied private right of action cannot exist thereunder. Yet the very Supreme Court cases on which Fischel relies recognize the private right of action under rule 10b-5. 93 Relying too heavily on the silence of section 10(b) as to secondary liability is inadvisable because “it would be disingenuous to suggest that . . . Congress in 1934 . . . foreordained the present state of the law with respect to Rule 10b-5.” 94 What that silence suggests most realistically is that Congress neither considered nor adopted any position on vicarious liability under section 10(b) based on common law principles.

Since the language and legislative history of section 10(b) do not resolve the issue, it may be helpful to consider vicarious liability in common law deceit actions. As noted above in Part I, an employer may be held liable without fault under the doctrine of respondeat superior for fraud committed by its employee in the scope of employment. 95 Since Congress intended section 10(b) to result in greater protection of securities investors than was afforded at common law, courts should be reluctant to disallow under section 10(b) the respondeat superior liability that existed for common law deceit unless the special context of securities trading makes respondeat superior liability undesirable. It is argued below that the application of respondeat superior under section 10(b) is particularly suitable.

2. The Justification for Respondeat Superior Liability Under Section 10(b)

If respondeat superior is allowed under rule 10b-5, it will coexist as a source of secondary liability with the controlling persons provision of section 20(a). The crucial implication of this is that two classes of secondary defendants will be created. Employers of rule 10b-5 violators may be held liable irrespective of personal fault under respondeat superior, whereas other controlling persons of rule 10b-5 violators will have available the good faith defense under section 20(a). 96 Although such a bifurcated treatment of secondary liability under rule 10b-5 may

93. See note 13 and accompanying text supra and cases cited at note 91 supra.
95. See text accompanying notes 23-27 supra.
96. The only case which has explicitly noted this implication of allowing respondeat superior under rule 10b-5 is Jackson v. Bache & Co., 381 F. Supp. 71 (N.D. Cal. 1974):

Thus the only persons able to utilize the good faith defense would be those involved in a situation where no agency relationship had been established. Accordingly, two groups of potential defendants would be created—those controlling persons who also happen to meet agency requirements as a principal and thus will not have a good faith defense
initially appear inelegant, it is quite suitable when examined in terms of the several common law rationales that have emerged in support of the no-fault liability imposed by respondeat superior. It is argued below that these rationales apply with particular force to brokerage firms in the securities trading context and that respondeat superior liability for rule 10b-5 violations will significantly further the policies that underlie section 10(b) and the 1934 Act. In contrast, the same rationales fail as applied to nonemployer controlling persons, as to whom the good faith defense afforded by section 20(a) produces more suitable results. Hence, the approach that best conforms to the policies of section 10(b) and the 1934 Act is the bifurcated treatment allowing respondeat superior and section 20(a) to coexist as sources of secondary liability.

In an important legal essay on respondeat superior, Professor Seavey has identified three major justifications for imposing liability without fault under the common law doctrine. First, since one who is strictly liable for injuries is particularly apt to take precautions to prevent them, respondeat superior usually results in greater care in the selection and supervision of employees. Second, it is generally very difficult to prove negligence in selecting and supervising employees, but

available and those controlling persons not considered principals who will not be held strictly liable.

*Id.* at 95 n.14. Without further discussion, Jackson concluded that it could "determine no rational reason for setting up different standards of liability within the federal securities framework," and that "if agency principles were adopted the good faith defense specifically contained in Section 20 would be emasculated." *Id.*


Since even in the absence of respondeat superior an employer would be liable for negligence in selecting and supervising his employees, it might be argued that respondeat superior does not make the employer more careful. If the cost of some precaution is less than the expected cost of injuries it would prevent, the employer will adopt the precaution whether subject to a negligence or a strict liability standard because failure to do so will result in liability under either standard and liability will cost more than prevention. Any precaution that is more costly than the injuries it would prevent will not be adopted under either standard, since the employer will not be liable under the negligence standard, and under the strict liability standard liability will be cheaper than prevention. Cf. R. Posner, *Economics Analysis of Law* 137-38 (2d ed. 1977). This argument presupposes a negligence standard perfectly gauged to impose liability if and only if the employer fails to take cost-justified precautions. However, judicial determination of a standard of reasonable care in selection and supervision of employees may be extremely troublesome due to the practically limitless variation in size and organizational structure of enterprises, the complex interdependence between selection, training, hierarchical placement and supervision of employees, and the taint of the initial finding of employee wrongdoing. Since the employer is best informed about the operating structure and history of employee torts in its own business organization, it is surely better situated than the court to identify what supervisory precautions are cost-justified. Thus, Seavey's suggestion that respondeat superior but not a negligence standard can generate the optimal level of employee tort prevention is well-motivated.
respondeat superior does not require such proof. Finally, the employer subject to respondeat superior liability is often much better situated than the injured person to spread the risk of employee torts through insurance, the cost of which may be shifted in the form of higher prices to consumers, who are the persons typically injured by employee torts. This insurance rationale further reinforces the prevention and evidentiary rationales, since the employer's ability to pass on respondeat superior judgment or insurance costs to consumers relieves concern over the justness of imposing liability on genuinely blameless employers. In this way, respondeat superior becomes a means of achieving optimal employee tort prevention and catching blameworthy employers who might escape a negligence standard.

Before examining the three common law rationales for respondeat superior in the context of securities fraud, the general purposes of section 10(b) and the 1934 Act must be examined, because they may not be entirely congruent with the purposes underlying the law of torts. The securities acts were intended largely for the protection of investors. Significantly, section 10(b) contains the explicit statement of purpose that rules promulgated thereunder are to be “necessary or appropriate in the public interest or for the protection of investors.” Investor protection is connected to the congressional policy of fostering public confidence in securities markets which underlies the securities acts. However, the policy of investor protection must be tempered by a policy of essential fairness to defendants held liable under the acts. The validity of respondeat superior liability for rule 10b-5 violations becomes clear upon viewing the common law rationales for re-

99. Seavey, supra note 97, at 449. If proof of negligence were required, “whether an employee was unfit at the time of the accident and whether there was improper supervision would ordinarily have to be proved by the testimony of fellow workers. Truthful testimony in such cases is difficult to obtain from the members of a well-disciplined organization.” Id.

100. Id. at 450-51. Seavey points out that if the business is of sufficient size . . . there may be actuarial experience with regard to the number of negligent acts performed by employees. In large enterprises, recurring harms, while regarded individually as accidents, are not such when considered as a unit and with reference to the entire business . . . . Without insurance, the burden upon an individual employer conducting a small business might be too great . . . . But with insurance this hardship disappears.


102. Not surprisingly, the prevention, evidentiary, and insurance rationales in favor of respondeat superior each surface in discussions justifying strict product liability in tort. See Escola v. Coca Cola Bottling Co., 24 Cal. 2d 453, 462-63, 150 P.2d 436, 441 (1944) (Traynor, J., concurring); W. Prosser, supra note 24, at 656-82.

103. See 5 A. Jacobs, supra note 80, § 6.06 and cases cited therein.


105. See 5 A. Jacobs, supra note 80, §§ 6.01, 6.08.

106. Id. § 6.07.
spondeat superior together with the policies that section 10(b) encourages.

Consider first the prevention rationale. In the absence of respondeat superior, a brokerage firm whose employee violates rule 10b-5 would be liable only if it failed to meet the good faith defense of section 20(a) by showing that it maintained a reasonable system of supervision and internal control over employees to prevent securities fraud. The supervision standard should theoretically impose liability if and only if the firm fails to take cost-justified fraud prevention measures. But it is doubtful that the court can very well approximate the ideal. The judicial standard of adequate supervision may prove to be too low where the firm’s supervisory procedures appear normal against the comparative backdrop of chronically inadequate trade practices, where the court is skeptical that supervisory precautions can detect the fraud of an employee bent on concealment, or where the court lacks sympathy for a relatively sophisticated plaintiff such as another brokerage firm. If the standard is set too low, brokerage firms will decline to take some economically efficient prevention measures. Conversely, the judicial standard of adequate supervision may tend to be too stringent where the court is overly averse to the risk of securities fraud, too highly protective of investors, or unsympathetic toward brokerage firms. Too stringent a standard is undesirable because it mistakenly labels as negligent some firms that have supervised reasonably well and inevitably results in unequal treatment among blameless firms. Seavey’s prevention rationale argues that respondeat superior liability for rule 10b-5 violations will result in the most economically efficient level of fraud prevention, since the employer who is strictly liable can be expected to minimize the total of supervisory prevention costs and employee fraud costs. To the extent respondeat superior may prevent fraud committed by brokerage employees, it furthers the investor protection policy stated in section 10(b) and promotes the integrity of securities trading markets.

In contrast, consider the good faith standard of section 20(a) as applied to a nonemployer controlling person, such as a director of a corporation whose president commits securities fraud. The director can meet the good faith defense by showing that he neither knew nor had reason to know of the officer’s fraud. The standard of diligence required of the director resembles that traditionally required in cases of breach of fiduciary duty and ordinary negligence. The court in this context should be competent to determine whether the director actually met the standard. Imposing strict liability on the already diligent direc-

107. See notes 18, 20-21, and accompanying text supra.
108. See note 22 and accompanying text supra.
tor would not cause him to take significant additional fraud preventive measures because "[d]irectors cannot be expected to exercise the kind of supervision over a corporation president that brokers must exercise over salesmen."^{109}

Now consider the evidentiary rationale. Although the burden of proving good faith under section 20(a) is on the defendant, it is likely that too many blameworthy brokerage firms can make a showing of apparently adequate supervision. The problem is that in advance of a rule 10b-5 violation by an employee, the nature of the showing of supervision that the firm must make under section 20(a) is largely predictable. The firm anticipating the inevitable occurrences of employee fraud that will arise can effectively manufacture its section 20(a) defense before the fact by organizing supervisory structures that look impressive on paper but need not be designed to be genuinely effective as applied. Without respondeat superior, the availability of the section 20(a) defense unfortunately creates an incentive for brokerage firms to maximize the cosmetic value, rather than the actual preventive value of their selection and supervision procedures. Thus, the adequate supervision defense is insufficiently protective of defrauded plaintiffs and is unfair to genuinely well-supervised firms. Holding brokerage firms vicariously liable for their employees' rule 10b-5 violations under respondeat superior circumvents the evidentiary problem, since proof of careful supervision becomes irrelevant. Respondeat superior is actually more fair to truly well-run firms, because although firms are held liable without fault for employee fraud, their aggregate judgment costs will presumably be lower the more carefully they actually supervise their employees.

Allowing a good faith defense to other sorts of controlling persons creates no such evidentiary difficulty. For instance, the director found to be a controlling person of his corporation's president must, in order to meet the good faith defense of section 20(a), begin by showing that he did not know of the president's fraud. The controlling director will often be able to claim truthfully that the fraud came as a surprise to him, unlike the brokerage firm that was certain as an actuarial matter to have to defend itself in employee fraud cases. Thus, the director's showing that even with reasonable diligence he could not have detected the fraud cannot be based on prefabricated evidence in the same way the brokerage firm could manufacture supervisory procedures merely on paper in anticipation of section 20(a) litigation. There is therefore no reason to expect too many blameworthy nonemployer controlling persons to slip through the section 20(a) net.

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The common law prevention and evidentiary rationales favoring respondeat superior indicate that its use in rule 10b-5 actions would significantly further the section 10(b) and 1934 Act policies of protecting investors and fostering public confidence in securities markets. The insurance rationale assures the essential fairness to honest brokerage firms of respondeat superior liability for rule 10b-5 violations. Assume that dishonest brokerage employees are sometimes clever enough or lucky enough to perpetrate securities fraud schemes that go undetected even in an efficiently supervised firm. The blameless firm must pay rule 10b-5 judgments, settlements, or liability insurance costs reflecting this threshold level of securities fraud because of respondeat superior. As long as the business of providing brokerage services is competitive, however, the blameless firm is able to pass on the threshold amount of fraud costs to its clients since every other firm also pays for at least a comparable threshold level of employee fraud. Most importantly, the clients who will ultimately pay these costs, perhaps in the form of increased commission charges, are precisely the class of investors that Congress enacted section 10(b) to protect. Since the well-supervised firm does not ultimately bear these fraud costs but rather spreads them among its investing clients, imposing liability without fault on such a firm via respondeat superior is not unfair. And to the extent that employee fraud in a brokerage firm goes undetected because of faulty supervision, the firm will be unable to pass resulting rule 10b-5 judgment costs on to its customers. This is also a fair outcome. Thus, respondeat superior liability for brokerage firms under rule 10b-5 promotes the section 10(b) policy of investor protection by spreading the risk of securities fraud, and it also promotes the complementary policy of essential fairness to defendants held liable under the securities acts.

To hold nonemployer controlling persons strictly liable for fraud committed by persons they control would generally be unfair. For instance, a director held liable as a section 20(a) controlling person for fraud committed by the president of a corporation is obviously unable to pass his judgment costs to anyone.\(^{10}\) If he is to blame for al-

\(^{10}\) It might be argued that the blameless director could perhaps be protected from the loss through purchase by the corporation of insurance covering directors’ liabilities. The coverage needed would be more costly than may initially be apparent, because while nominally insuring the director against strict liability, it would effectively insure against fraud committed by anyone to whom the director was a controlling person. If such coverage were available, the fraud loss would be shifted in the form of insurance costs to the corporation and ultimately to the shareholders. This raises the question of whether it is just to place the burden on the corporation. When a corporate officer commits fraud in the scope of his employment or within his actual or apparent authority, agency principles already require the corporation to bear the fraud loss, or insure against it, as a cost of doing business. If strict secondary liability for directors were the rule, the corporation would also effectively pay when the officer has committed fraud outside the scope of employment and apparent authority, as for example where an officer secretly commits fraud when
lowing the president's scheme to go undetected, it is fair that he be required to compensate the innocent victim of the fraud. However, if the director has acted with reasonable diligence, it would be quite unjust to force him to shoulder the burden of the loss. Thus, fairness requires that nonemployer controlling persons, who cannot distribute and spread judgment costs, be permitted to exonerate themselves through a good faith defense like that provided in section 20(a).

To summarize, the common law prevention, evidentiary, and insurance rationales justifying respondeat superior apply with special force to securities brokerage firms. These rationales suggest that respondeat superior liability for rule 10b-5 violations advances the congressional purposes of section 10(b) and the 1934 Act to protect investors and foster public confidence in securities markets while assuring fair treatment of brokerage firms. The same rationales favoring strict liability do not apply to nonemployer controlling persons, as to whom allowing the good faith defense of section 20(a) produces more appropriate results. Therefore, the policies of section 10(b) and the 1934 Act are best fulfilled by permitting respondeat superior and section 20(a) to coexist as sources of secondary liability for rule 10b-5 violations.111

...
Two contrary positions have developed in the case law on the issue of whether an employer may be held vicariously liable based on the common law doctrine of respondeat superior for conduct of its employee which violates rule 10b-5. The Ninth and Third Circuits view section 20(a), the controlling persons provision of the Securities Exchange Act of 1934, as the exclusive source of secondary liability for rule 10b-5 violations. The Second and Fifth Circuits have ruled that section 20(a) does not preclude the application of common law theories of secondary liability and that brokerage firms may be held liable based on respondeat superior for rule 10b-5 violations.

This Comment has argued that neither the language nor legislative history of section 20(a) supports the view that common law principles of secondary liability are excluded under the 1934 Act. Furthermore, in light of the relation of section 10(b) to the common law of deceit, it would be inappropriate to disallow respondeat superior liability under section 10(b) for employee fraud that exists at common law unless the special context of securities trading made respondeat superior unsuitable. The common law rationales justifying the vicarious liability that respondeat superior creates are especially applicable to brokerage firms in the securities trading context and indicate that respondeat superior liability for rule 10b-5 violations significantly furthers the purposes of section 10(b) and the 1934 Act generally. Those rationales are inapplicable to nonemployer controlling persons, and the purposes of section 10(b) are better served by allowing such persons the good faith defense contained in section 20(a). In conclusion, respondeat superior should be permitted to coexist with section 20(a) as a source of secondary liability for violations of section 10(b) and rule 10b-5.

William J. Seiter*

An investor comes to a broker-dealer because the house holds itself out as competent in the handling of investments. The investor obviously understands that he bears the risk that the value of his investment may fluctuate according to the vicissitudes of the market and the acumen of his broker-dealer, but he does not undertake the risk that an agent of the broker-dealer will deal fraudulently with his account.

The rationale favoring strict liability of a principal for misrepresentations of its agent made within his apparent authority does not apply to nonprincipal controlling persons. Suppose a director is considered a section 20(a) controlling person of a corporate officer who commits rule 10b-5 fraud. Since the officer is an agent of the corporation but not of the individual director, the victim cannot have thought that the officer was acting for the benefit of the director in the fraudulent transaction. That is, the officer may have been acting within his apparent authority as an agent of the corporation, but not of the director. So it would generally be unjust to use the common law doctrine of apparent authority to hold nonprincipal controlling persons strictly liable.

* B.A. 1974, M.A. 1975, Ph.D. in Linguistics, 1979, University of California at San Diego; third-year student, Boalt Hall School of Law, University of California, Berkeley.