

CONTROL PERSON LIABILITY UNDER
SECTION 20(A):

*STRIKING A BALANCE OF INTERESTS FOR
PLAINTIFFS AND DEFENDANTS*

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INTRODUCTION

Control person liability under § 20(a) came into existence over seventy years ago with the enactment of the Securities

* LL.M., Securities and Financial Regulation, Georgetown University Law Center, 2005. Many thanks to Professor Donald C. Langevoort, who prompted and guided me in the publication of this paper. The views expressed in this paper are solely those of the author.

Exchange Act of 1934.¹ Despite its long history, courts have allowed § 20(a) and the concept of control person liability to elude more precise definition.² The result is the absence of a settled rule of law at a time when an increasing number of individuals find themselves embroiled in corporate scandals and the subject of regulatory scrutiny.³ Given this fact, the need for a more uniform application of § 20(a) has never been more important than at present.

Most recently, suits have been filed under § 20(a) in response to the scandals at Fannie Mae⁴, Marsh & McLennan⁵, AIG,⁶ and Vivendi.⁷ Eclipsing those cases are the large-scale and widely publicized § 20(a) claims related to the collapse of WorldCom,⁸ Adelphia,⁹ and Enron.¹⁰ In these suits, plaintiffs seek not only corporate accountability, but also accountability from individuals who caused or were in a position to prevent the problems. More often, this means that plaintiffs are bringing allegations against outside individuals, such as the accountants, auditors, and lawyers, in addition to the company's officers and directors.

1. Securities Exchange Act of 1934, ch. 404, § 20(a), 48 Stat. 881, 899 (codified as amended at 15 U.S.C. § 78t(a) (2000)).

2. Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 266 (1997).

3. See MARK JICKLING & PAUL H. JANOV, CRIMINAL CHARGES IN CORPORATE SCANDALS (Cong. Research Serv., CRS Report for Congress Order Code RL31866, Dec. 5, 2003), available at <http://www.thememoryhole.org/crs/more-reports/RL31866.pdf>.

4. Ohio Pub. Employees Ret. Sys. v. Fannie Mae, 357 F. Supp. 2d 1027, 1032 (S.D. Ohio 2005).

5. Class Action Complaint at 22, Schulman v. Putnam Am. Gov't Income Fund, No. 1:03-cv-08323-DAB (S.D.N.Y. dated Oct. 21, 2003) available at http://securities.stanford.edu/1028/MMC0301/20031021_f01c_Schulman%20and%20Fisher.pdf.

6. Brief for Plaintiffs, Noll v. Am. Int'l Group, Inc., 2004 WL 2733762 (S.D.N.Y. Oct. 18, 2004) (No. 04-CV-08226).

7. Liberty Media Corp. v. Vivendi Universal, S.A., 2004 U.S. Dist. LEXIS 7015, at *8-9 (S.D.N.Y. Apr. 21, 2004).

8. See *In re WorldCom, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 2216, at *2 n.1 (S.D.N.Y. Feb. 18, 2005) (No. 02 Civ. 3288 (DLC)) (referencing sources identified in n.1: *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, No. 02 Civ. 3288(DLC), 2005 WL 89395 (S.D.N.Y. Jan. 18, 2005) (Andersen's motion for summary judgment); *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004) (Underwriter Defendants' motion for summary judgment); *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392 (S.D.N.Y. 2003) (deciding a number of defendants' motions to dismiss)). See also *In re WorldCom, Inc. Sec. Litig.*, 2004 WL 2591402 at *8 (S.D.N.Y. Nov. 12, 2004) (No. 02 Civ. 3288 (DLC)) (settling Citigroup's claim for \$2.65 billion).

9. *In re Adelphia Commc'ns Corp. Sec. & Derivative Litig.*, 2005 U.S. Dist. LEXIS 17134 (S.D.N.Y. 2005).

10. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002), dismissed in part by No. H-01-3624, 2003 U.S. Dist. LEXIS 1668 (S.D. Tex. Jan. 28, 2003) [hereinafter *In re Enron*].

As liability under § 20(a) continues to pose a significant threat of exposure for many individuals, it is important to understand where the law stands regarding liability under this provision. Accordingly, this paper provides an overview of § 20(a)'s background, illustrates where the law is now, and makes suggestions for the future application of § 20(a). Using the *Enron* litigation as a guide in all that can go wrong in corporate control, this paper seeks to illustrate that it is necessary to adopt a more flexible approach to what constitutes "control" under § 20(a) and a more certain level of culpability to defeat or defend the provision's good faith defense.

Part I discusses § 20(a) generally. Part II examines the two primary tests used to determine whether plaintiffs have successfully pleaded control person liability under § 20(a). Part III then explores the advantages and disadvantages associated with each test. Finally, Part IV addresses the question of what should be the appropriate standard of care under § 20(a). To illustrate a standard that effectively achieves a balance of interests, this paper looks at the district court's ruling in the *Enron* litigation, particularly focusing on the court's applicable standard of care for the defendant's good faith defense. Ultimately, this paper concludes that some culpability must be shown to defeat the good faith defense, which provides the only successful balancing of interests in § 20(a) liability and should be more widely adopted by the circuits.

I. PART I: SECTION 20(A)

A. *History*

The stock market crash of 1929 served as the impetus for Congress' enactment of the federal securities laws.¹¹ Congress sought to restore confidence in the U.S. securities market and to address the public outrage that many who engaged in the most egregious conduct leading up to the crash were insulated from liability by the shield of the legal corporate entity.¹² In the hearings preceding the passage of the Securities Act, Congress referred to correcting the "dangerous and unreliable system of depending upon dummy directors" that lack any accountability or responsibility for their actions.¹³

11. See H.R. Rep. No. 73-1383, at 6 (1934).

12. See Carson, *supra* note 2, at 268-69.

13. S. Rep. No. 73-47, at 5-6 (1933). See Stock Exchange Practices: Hearing on S. Res. 84 (72nd Cong.) and S. Res. 56 and 97 (73rd Cong.) Before the Senate Comm. on

Consequently, Congress not only sought to establish a comprehensive regulatory framework that would prevent such devastation from recurring, but also to impose greater accountability on those involved in corporate and market fraud.¹⁴ The result of Congress' efforts was the Securities Act of 1933 and the Exchange Act of 1934.¹⁵

B. *Framework*

Within each Act, Congress included provisions that allowed for individual liability of those who had a control relationship with a primary violator of the securities laws. Section 20(a), in pertinent part, states:

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 of cause of action.¹⁶

Congress did not define "control" in either Act, leaving the courts the flexibility to interpret this provision in their best, and often varying, judgment.¹⁷

Congress intentionally omitted any definition because, "it was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or anticipate the many

Banking and Currency, 73rd Cong., 1st Sess. 6556 (1934) (remark of Sen. Alben W. Barkley).

14. See H.R. Rep. No. 73-1383, at 5 (1934). Quoting President Woodrow Wilson, Chairman Rayburn stated:

Society cannot afford to have individuals wield the power of thousands without personal responsibility. It cannot afford to let its strongest men be the only men who are inaccessible to the law. Modern democratic society, in particular, cannot afford to constitute its economic undertakings upon the monarchial or aristocratic principle and adopt the fiction that the kings and great men thus set up can do no wrong which will make them personally amenable to the law which restrains smaller men; that their kingdom, not themselves, must suffer for their blindness, their follies, and their transgressions of right. *Id.*

15. See Carson, *supra* note 2, at 268.

16. 15 U.S.C. § 78t(a) (1994).

17. See Carson, *supra* note 2, at 266.

ways in which actual control may be exerted.”¹⁸ However, the sparse legislative history does state that, “when reference is made to ‘control,’ the term is intended to include actual control as well as what has been called legally enforceable control.”¹⁹

C. *Distinguishing § 15*

Section 15 creates control person liability under the Securities Act of 1933.²⁰ Although the language of § 15 varies slightly from that of § 20(a), the courts often interpret the provisions in an interchangeable manner.²¹ The most notable difference between §§ 15 and 20(a) is that § 15 only applies where the controlled person violated §§ 11 and 12 of the Securities Act.²² Conversely, § 20(a) applies to all violations of the Exchange Act. This includes § 10(b) and Rule 10b-5 violations, which are the more widely litigated anti-fraud provisions of the Exchange Act. Thus, exposure to secondary liability is often greater under § 20(a).²³

The language of § 15’s defense is also different. It provides for liability, “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 control person is alleged to exist.”²⁴ Section 20 provides a good faith and non-inducement defense. The legislative history lacks any explanation for the variation in the two sections’ defenses. This is particularly unusual because Congress added the defense that presently exists in § 15 by amendment in 1934.²⁵

Finally, the language of § 15 provides a basis for determining control person status. The provision lists “stock ownership, lease, contract and agency” as non-exclusive examples

18. H.R. Rep. No. 73-1383, at 26 (1934).

19. *Id.* (citing *Handy & Harmon v. Burnet*, 284 U.S. 136 (1931)).

20. Securities Act of 1933, ch. 38, 48 Stat. 74, 84 (codified as amended at 15 U.S.C. § 77o (1994)).

21. See *In re Asia Pulp & Paper Sec. Litig.*, 293 F. Supp. 2d 391, 395 (S.D.N.Y. 2003) [hereinafter *In re Asia Pulp*]; *Farley v. Henson*, 11 F.3d 827, 835 (8th Cir. 1993); *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 n.7 (10th Cir. 1998); *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *45.

22. See 15 U.S.C. §§ 77k, 77l (1994). Section 77k (Securities Act § 11) creates liability for false registration statements. Section 77l (Securities Act § 12) creates liability for false information contained within a prospectus.

23. See Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 14-15 (2002).

24. 15 U.S.C. § 77o (1994).

25. See Securities Exchange Act of 1934, ch. 404, § 209, 48 Stat. 881, 908 (codified as amended at 15 U.S.C. § 77o (1994)).

of “control.”²⁶ While §§ 15 and 20(a) are supposedly interpreted synonymously, some have conjectured whether Congress illustrated its intent that those grounds for control person status only apply to § 15 by specifically leaving it out of § 20(a).²⁷

II. PART II: PREVAILING TESTS FOR DETERMINING CONTROL PERSON LIABILITY

In the absence of clear language or congressional direction, the U.S. Securities and Exchange Commission attempted to add clarity to the situation by defining control as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”²⁸ Many circuits refer to this definition in their opinions, but the definition is not controlling on the courts.²⁹ In fact, some courts completely ignore the SEC’s definition and apply their own alternative interpretation of “control.”³⁰

Most circuits choose to instead reference what little history that does exist. That history indicates an intent for § 20(a) to encompass a “concept of control [that] should be broadly construed with sufficient flexibility to cover many situations” as securities transactions evolve.³¹ Thus, in lieu of more particularized guidance, the circuits have interpreted control on a scale from highly restrictive to highly expansive. The current tests that determine control are: 1) culpable participation and 2) potential control.

A. Culpable Participation

Under the culpable participation theory of control, a § 20(a) claim has three elements. First, there must be a violation of the Exchange Act by a controlled person, otherwise referred to as a

26. H.R. REP. NO. 73-1383, § 19 (1934).

27. See Laura Greco, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 171-72 (1999).

28. 17 C.F.R. § 230.405 (2005). This definition was issued for the purposes of administrative proceedings.

29. See SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472-73 (2d Cir. 1996); *Maher*, 144 F.3d at 1305; *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *33.

30. See, e.g., *Sheinkopf v. Stone*, 927 F.2d 1259, 1270 (1st Cir. 1991); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. Feb. 1981); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1108 (10th Cir. 2003); *City of Monroe Employees. Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468, 484-85 (6th Cir. 2004).

31. *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *32 (citing Carson, *supra* note 2, at 274).

“primary violator.”³² Second, the defendant must have exercised control over the primary violator.³³ Third, the controlling person must have culpably participated in the fraud.³⁴ The Second, Third, and Fourth Circuits apply this test, though in varying degrees.

The culpable participation test is controversial because many believe the third element should be an affirmative defense for the defendant.³⁵ Under this theory, the plaintiff bears the burden of demonstrating, as part of its prima facie case, that the defendant willfully participated in the misconduct.³⁶ The Third and Fourth Circuits based their adoption of this test on the Supreme Court’s decision in *Ernst & Ernst v. Hochfelder*.³⁷ In that case, the Supreme Court indicated in dicta that a standard greater than negligence is required to assert a claim under § 20(a).³⁸

The circuits that advance this theory of control also point to the language of § 20(a) as evidence that culpable participation is required.³⁹ Section 20(a) states “unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation of cause of action.” These courts believe this language evinces Congress’ intent to require the secondary control person to possess the same requisite scienter as the primary violator.⁴⁰ Consequently, instead of the language creating an affirmative defense, courts require the plaintiff to show scienter on the part of the defendant in a manner similar to what plaintiffs must plead in a § 10(b) or Rule 10b-5 action.⁴¹

Over the last several years, courts applying the culpable participation test have been forced to address the pleading requirements of § 20(a)’s scienter element in light of the Private Securities Litigation Reform Act’s (“PSLRA”).⁴² Congress

32. See *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 885 (3d Cir. 1975).

33. See *Boguslavsky*, 159 F.3d at 720.

34. *Id.*

35. See, e.g., Bradford R. Turner, *Brown v. Enstar Group, Inc.: The Eleventh Circuit Opens the Door for Expansive Controlling Person Liability Under the 1933 and 1934 Securities Acts*, 32 GA. L. REV. 323, 338 (1997).

36. *In re Vivendi Universal Sec. Litig.*, 381 F. Supp. 2d 158, 184 (S.D.N.Y. 2003).

37. *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979). See also Bradford, *supra* note 23, at 338 n.95.

38. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.28 (1976).

39. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 885 (3d Cir. 1975).

40. *Id.*

41. *Id.*

42. See, e.g., *In re Criimi Mae, Inc. Sec. Litig.*, 94 F. Supp. 2d 652, 657 (D. Md.

enacted the PSLRA to discourage merit-less class action securities litigation by implementing several new procedural hurdles in the litigation process that makes it more difficult for investors to seek recovery for losses.⁴³ The PSLRA requires that, “in any private action arising under this chapter in which the plaintiff may recover damages only on proof that the defendant acted with a particular state of mind,” scienter must be plead with particularity.⁴⁴ The issue raised by Second Circuit courts was whether scienter is an element of a § 20(a) claim and thus, constitutes “a particular state of mind.”⁴⁵ In September 2004, a district court ruled in *In re Bayer Securities Litigation* that the PSLRA applies to actions brought under § 20(a).⁴⁶ Consequently, the plaintiffs were required to plead scienter with enough specificity to raise a “strong inference that the controlling person knew or should have known that the primary violator, over whom that person had control, was engaging in fraudulent conduct.”⁴⁷ However, there is an intra-circuit split on this issue.⁴⁸

In the month following the *In re Bayer* decision, a court in the same district made the exact opposite ruling. In *In re Initial Public Offering Securities Litigation*, the court held that scienter is not an element of § 20(a) and thus, the PSLRA (as well as Rule 9(b) of the Federal Rules of Civil Procedure) does not apply.⁴⁹ As a result, the court held that it was only necessary for the plaintiff to allege a primary violation by the controlled person and direct or indirect control of the primary violator by the defendant.⁵⁰

2000).

43. See *Securities Litigation Abuses: Before the Securities Subcomm. of the Senate Comm. on Banking, Housing and Urban Affairs*, 105th Cong. (1997) (statement of Richard I. Miller, General Counsel, AICPA), 1997 WL 416660.

44. 15 U.S.C. § 78u-4(b)(2) (2000).

45. *In re Bayer AG Sec. Litig.*, No. 03 Civ. 1546 (WHP), 2004 U.S. Dist. LEXIS 19593, at *49 (S.D.N.Y. Sept. 30, 2004).

46. *Id.*

47. *Burstyn v. Worldwide Xceed Group, Inc.*, No. 01 Civ. 1125 (GEL), 2002 U.S. Dist. LEXIS 18555, at *25 (S.D.N.Y. Sept. 30, 2002).

48. See *In re Livent Inc. Sec. Litig.*, 151 F. Supp. 2d 371, 414 (S.D.N.Y. 2001) (discussing the intra-circuit split). Compare *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 395-96 (S.D.N.Y. 2003) (holding that claims under § 20(a) are subject only to the pleading standards of Rule 8(a)) [hereinafter *In re IPO*], with *Burstyn*, 2002 U.S. Dist. LEXIS 18555, at *24 (concluding that heightened pleading requirements of PSLRA apply to § 20(a) claims).

49. *In re Rediff.com India Ltd. Sec. Litig.*, 358 F. Supp. 2d 189, 208 (S.D.N.Y. 2004) (citing *In re IPO*, 241 F. Supp. 2d at 396-97).

50. *Id.* at 208 (citing *In re Worldcom, Inc.*, 294 F. Supp. 2d 392, 414 (S.D.N.Y. 2003)).

1. Are “culpable participation” circuits beginning to soften?

The split may indicate that circuits applying the culpable participation test are beginning to waiver in their adherence to such a strict pleading standard.⁵¹ When a district court in the Southern District of New York granted the defendants’ motion to dismiss in *In re Asia Pulp and Paper Securities Litigation*, it noted that plaintiffs “need only plead facts supporting a reasonable inference of control.”⁵² However, supporting a “reasonable inference of control” may still be a difficult obstacle to overcome at the pleading stage.

In *Asia Pulp*, plaintiffs sued an accounting firm as a control person by virtue of its relationship to the outside auditing firm. The court held that the plaintiffs had only alleged that the defendant set the individual offices’ professional operational standards and principles.⁵³ However, without any allegations that the defendant, “pursuant to an agreement or otherwise, was able to control, or in any way influence the particular audits conducted or opinions offered by the individual member firms,” the complaint failed to state a claim under § 20(a).⁵⁴

Since *Asia Pulp*, other courts in the same district have shown increasing leniency when interpreting the standard for making out a claim under § 20(a). In *In re Philip Services Corporation*, the court denied the defendants’ motions to dismiss for failure to state a claim under § 20(a).⁵⁵ In its opinion, the court held that to sufficiently plead the second element of a § 20(a) action (control) the plaintiffs must give, “a short, plain statement that gives the defendant fair notice of the claim that defendant was a control person and the ground on which [that claim] rests.”⁵⁶ The court held that plaintiffs satisfied this by alleging that defendants were directors of the corporation and

51. See *In re Reliance Corp. Sec. Litig.*, 135 F. Supp. 2d 480, 518 (D. Del. 2001) (citing the Seventh Circuit’s definition of control in *Donohue v. Consol. Operating & Prod. Corp.*, 30 F.3d 907, 911-12 (7th Cir. 1994)). See also *In re Xerox Corp. Sec. Litig.*, 165 F. Supp. 2d 208, 220 (D. Conn. 2001).

52. *In re Asia Pulp*, 293 F. Supp. 2d at 396 (citing *Gabriel Capital v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 426-27 (S.D.N.Y. 2000) (citations omitted)).

53. *In re Asia Pulp*, 293 F. Supp. 2d. at 396.

54. *Id.*

55. *In re Philip Servs. Corp. Sec. Litig.*, No. 98 Civ. 0835 (MBM), 2004 U.S. Dist. LEXIS 9261, at *67-68 (S.D.N.Y. May 24, 2004); see also *In Re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 515-16 (S.D.N.Y. 2005) (explicitly holding that it is unnecessary for plaintiffs to allege some culpable participation on the part of the control person).

56. *Id.* at *61 (quoting *Schnall v. Annuity & Life Re (Holdings), Ltd.*, No. 3:02 CV 2133 (GLG), 2004 U.S. Dist. LEXIS 1601, at *25 (D. Conn. Feb. 4, 2004)).

that they signed a false registration statement. The court acknowledged that:

While there is case law suggesting that a defendant's execution of a fraudulent SEC filing is insufficient by itself to establish control, [the court] share[s] the view that it "comports with common sense to presume that person who signs his name to a report has some measure of control over those who write the report."⁵⁷

The court was equally lenient on the third element when it stated that although the defendants "may prefer a more particularized description" of the facts that constitute the fraud, "such facts are peculiarly within [the defendants'] own knowledge, and plaintiffs should not be expected to plead them in the Complaint."⁵⁸

B. *Potential Control*

The majority of circuits apply an alternative standard for control person liability called the potential control test. Although considerable variation exists under the penumbra of this title, the focus is generally on whether the defendant had the potential to, or actually did, control the primary violator.⁵⁹

The Eighth Circuit articulated the most widely adopted standard for determining § 20(a) control person liability in *Metge v. Baehler*.⁶⁰ In that case, the court established a two-part test:

The plaintiff had to prove that the defendant, "actually participated in (*i.e.* exercised control over) the operations of the corporation [or person] in general."

Then, the plaintiff "must prove that the defendant possessed the power to control the specific transaction upon which the primary violation is predicated."⁶¹

Shortly after the Eighth Circuit articulated this test, the Sixth Circuit adopted the same standard to determine control and continues to consistently apply it in its decisions.⁶²

57. *Id.* at *62 (citations omitted) (quoting *Jacobs v. Coopers & Lybrand, L.L.P.*, No. 97 Civ. 3374 (RPP), 1999 U.S. Dist. LEXIS 2102, at *51 (S.D.N.Y. Feb. 26, 1999).

58. *Id.* at *66.

59. *See, e.g., City of Painesville, Ohio v. First Montauk Fin. Corp.*, 178 F.R.D. 180, 192 (N.D. Ohio 1998).

60. *Metge v. Baehler*, 762 F.2d 621, 630-31 (8th Cir. 1985).

61. *Id.* (quoting *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984)).

62. *See City of Painesville*, 178 F.R.D. at 192 n.19; *City of Monroe Employees Ret.*

The Seventh Circuit also adopted a similar test in *Harrison v. Dean Witter Reynolds, Inc.*⁶³ Shortly thereafter, *Donohoe v. Consolidated Operating and Production Corporation* affirmed *Harrison* while expressly rejecting the culpable participation test.⁶⁴ The Seventh Circuit expressed the concern that, under the culpable participation standard, “corporate officers and directors could escape controlling liability by remaining as ignorant as possible – surely not the result that Congress intended.”⁶⁵ Instead, the court held that the emphasis should be on whether the defendant has “the practical ability to direct the actions of the people who issue or sell the securities.”⁶⁶

The First Circuit has yet to specifically address whether culpable participation is an element of § 20(a).⁶⁷ In *Aldridge v. A.T. Cross Corp.*, the First Circuit held that the alleged controlling person must not only have the general power to control the company, but must also exercise control over the company.⁶⁸ A later First Circuit district court noted that, “even if culpable participation is required, . . . it appears from the First Circuit’s decision in *Aldridge* that [a plaintiff satisfies the test by] showing that [the] defendant was an active participant in the decision-making process.”⁶⁹ Thus, directors, officers, and controlling shareholders only act as control persons if they “dominated the activities of the corporate entity.”⁷⁰ Once the plaintiff establishes a primary violation by the controlled entity and, that the defendant was a “controlling person” within the meaning of the statute, “the burden shifts to the defendant to show that he acted in good faith.”⁷¹

This formula was tested in the recent *Tyco* litigation.⁷² In *In*

Sys. v. Bridgestone Corp., 387 F.3d 468, 484 (6th Cir. 2004).

63. *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992).

64. *Donohoe v. Consol. Operating & Prod. Corp.*, 982 F.2d 1130, 1138 n.7 (7th Cir. 1992).

65. *Id.* at 1138.

66. *Id.* (quoting *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986)).

67. *See Brody v. Stone & Webster, Inc.*, 424 F.3d 24, 26 n.2 (1st Cir. 2005); *Neely v. Bar Harbor Bankshares*, 270 F. Supp. 2d 50, 54 (D. Me. 2003) (citing *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 (1st Cir. 2002)).

68. *Aldridge*, 284 F.3d at 85 (citing *Sheinkoft v. Stone*, 927 F.2d 1259, 1270 (1st Cir. 1991); and *Harrison*, 974 F.2d 873, 880-81 (7th Cir. 1992)).

69. *Neely*, 270 F. Supp. 2d at 54 (citing *Aldridge*, 284 F.3d at 85).

70. *Rand v. M/A-Com, Inc.*, 824 F. Supp. 242, 262 (D. Mass. 1992) (citing *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105, 1122 (D.R.I. 1990)).

71. *Neely*, 270 F. Supp. 2d at 53 (D. Me. 2003).

72. *See In re Tyco Int’l, Ltd. Multidistrict Litig.*, No. 02-266-B, 2004 U.S. Dist. LEXIS 20733, at *51 (D.N.H. Oct. 14, 2004) (citing *Aldridge*, 284 F.3d at 85).

re Tyco International, Ltd. Multidistrict Litigation, the defendants were directors who allegedly signed false SEC filings on Tyco's behalf.⁷³ Shareholders brought suit against Tyco's directors after Tyco was forced to take a \$382.2 million pre-tax adjustment to its 2002 financial statements⁷⁴ and another \$1.1 billion in after-tax charges after "unearthing fresh accounting problems."⁷⁵ The court held that asserting that "a person was a member of a corporation's board of directors, without any allegation that the person individually exerted control or influence over the day-to-day operations of the company, does not suffice to support an allegation that the person is a control person."⁷⁶

The Tenth Circuit espouses a similar approach to determine control person liability.⁷⁷ In *Adams v. Kinder-Morgan, Inc.*, the Tenth Circuit rejected the requirement that a plaintiff must show that the defendant culpably participated in the primary violation.⁷⁸ There, the court found no controlling person liability for individuals who acted as directors but had no role in the day-to-day operations of the corporation.⁷⁹ However, the CEO's role in managing the day-to-day operations of the corporation was a sufficient allegation of control.⁸⁰ The court also held that the ability to acquire control is inadequate to withstand summary judgment.⁸¹ Finally, the court held that where the fraud specifically pertained to financial reports, the court was able to make an inference of control against the CFO.⁸²

Originally, the Ninth Circuit espoused a culpable participation test for control person liability.⁸³ By 1990, the

73. *In re Tyco Int'l, Ltd. Multidistrict Litig.*, 2004 U.S. Dist. LEXIS 20733 at *52.

74. Tyco Int'l Ltd., Current Report (Fork 8-K), at 5 (Dec. 30, 2002).

75. USA TODAY, *Tyco Shareholders Allege \$6 Billion Fraud* (June 6, 2003), available at http://www.usatoday.com/money/industries/manufacturing/2003-06-06-tyco-shareholders_x.htm.

76. *In re Tyco Int'l, Ltd. Multidistrict Litig.*, 2004 U.S. Dist. LEXIS 20733 at *52 (citing *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1108 (10th Cir. 2003)).

77. *Adams*, 340 F.3d at 1107 (citing *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1270-71 (10th Cir. 2001)).

78. *Id.* at 1109 (citing *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998)).

79. *Id.* at 1108 (citing *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 509-10 (5th Cir. 1990), *Burgess v. Premier Corp.*, 727 F.2d 826, 832 (9th Cir. 1984) and *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187, 195 (5th Cir. 1980)).

80. *Id.*

81. *Id.* (citing *Dennis*, 918 F.2d at 509-10; *Burgess*, 727 F.2d at 832; and *Cameron*, 608 F.2d at 195).

82. *Id.* at 1109.

83. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1574 (9th Cir. 1990) (citing *Buhler v. Audio Leasing Corp.*, 807 F.2d 833, 835-36 (9th Cir. 1987); and *Christoffel v.*

court in *Hollinger v. Titan Capital Corp.* noted that the circuit had shifted to a broader interpretation of § 20(a) that closely resembled the potential control approach.⁸⁴ In 2002, the Ninth Circuit held, “to be liable as control persons, [defendants] must have participated in [the company’s] operations or exerted ‘some influence’ therein.”⁸⁵ The burden of pleading a good faith defense rests squarely with the defendant.⁸⁶

As early as 1997, a California district court within the Ninth Circuit found that alleging a defendant’s position as a director and an officer and his “substantial” stock ownership was sufficient to overcome a motion to dismiss.⁸⁷ More recently, the Northern District of California decided a § 20(a) claim that alleged the defendants caused the company to issue false financial reports.⁸⁸ The court relied on its own earlier opinion in *In re Adaptive Broadband Securities Litigation*, which held that holding a high-level position within the company satisfies the standard for control person liability.⁸⁹ *In re Network Associates* reflects the Ninth Circuit’s shift to a much more expansive interpretation of § 20(a).

The Eleventh Circuit, in an unexpected opinion, adopted a variation on the *Metge* test with its 1997 decision in, *Brown v. Enstar Group, Inc.*⁹⁰ There, the court found that an individual was a controlling person if he “had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.”⁹¹ Similar to the Seventh Circuit, the Eleventh Circuit finds it unnecessary to distinguish whether the defendant actually controlled the violator or simply was in a position to do so.⁹² In contrast to the

E.F. Hutton & Co., 588 F.2d 665, 668-69 (9th Cir. 1978)).

84. *Hollinger*, 914 F.2d at 1575.

85. *Peltz v. Polyphase Corp.*, 36 Fed. Appx. 316, 321 (9th Cir. 2002) (citing *Burgess*, 727 F.2d at 832).

86. *Hollinger*, 914 F.2d at 1575.

87. *Powers v. Eichen*, 977 F. Supp. 1031, 1045 n.9 (S.D. Cal. 1997).

88. *In re Network Assocs., Inc. II Sec. Litig.*, 2003 U.S. Dist. LEXIS 14442, at *8-9 (N.D. Cal. Mar. 25, 2003).

89. *Id.* at *48-49 (citing *In re Adaptive Broadband Sec. Litig.*, 2002 U.S. Dist. LEXIS 5887, at *57 (N.D. Cal. Apr. 2, 2002) (stating “the fact that the named individual defendant’s held important positions in the company is sufficient at the pleadings stage” to state a claim under § 20(a))).

90. *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396-97 (11th Cir. 1996).

91. *Id.* at 396 (quoting *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)) (alteration in original).

92. *Enstar*, 84 F.3d at 397. *See also In re Miller Indus., Inc.*, 12 F. Supp. 2d 1323, 1333 (N.D. Ga. 1998) (finding that plaintiffs adequately presented a cause of action for

Metge test, plaintiffs in the Eleventh Circuit do not need to show that defendants had actual control over the general affairs of the corporation.⁹³ Rather, the ability to exert power over the violating transaction is sufficient to state a claim.⁹⁴

The Fifth Circuit employs a very similar test to the Eleventh Circuit for pleading § 20(a) liability.⁹⁵ In the Fifth Circuit, “the plaintiff needs to allege some facts beyond a defendant’s position or title to show that the defendant had actual power or control over the controlled person.”⁹⁶ However, it is unclear whether the Fifth Circuit has adopted the first prong of the *Metge* test, which requires that the defendant actually participated in the general operations of the corporation.⁹⁷ Fifth Circuit cases in which the pleadings sufficiently asserted control include allegations that the defendants: were involved in the day-to-day control of the corporation’s operations,⁹⁸ had knowledge of the underlying primary violation by the controlled person,⁹⁹ or had the requisite power directly or indirectly to control or influence corporate policies.¹⁰⁰ In the recent Enron litigation, the Texas district court appeared to be moving toward a rule that would not require *Metge*’s first prong.¹⁰¹

III. PART III: CRITICAL ASSESSMENT OF THE CIRCUIT TESTS

The above survey of what a plaintiff must show in the different circuits to assert a claim under § 20(a) highlights the deficiencies that exist within each approach. Addressing the strengths and weaknesses of each test provides the most effective means of identifying the positive attributes of each test that should be incorporated in an attempt to align them.

control person liability by alleging defendants’ positions of authority within the corporation as officers and directors enabled them to exercise the requisite control over the corporation’s affairs).

93. *Enstar*, 84 F.3d at 397, n.6.

94. *See id.*

95. *See* *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Dynege, Inc.*, 339 F. Supp. 2d 804, 828 (S.D. Tex. 2004) [hereinafter *In re Dynege, Inc.*].

96. *In re Dynege, Inc.*, 339 F. Supp. 2d at 828 (citing *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509-10 (5th Cir. 1990)).

97. *See In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *38.

98. *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187, 195 (5th Cir. 1979), *aff’d in part, vacated and remanded in part on rehearing*, 611 F.2d 105 (5th Cir. 1980).

99. *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959 (5th Cir. Feb. 1981).

100. *Dennis*, 918 F.2d at 509-10 (citing *G.A. Thompson*, 636 F.2d, at 957-58).

101. *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *65-66.

A. *Acknowledging Corporate Realities*

Proponents of the more difficult culpable participation test might argue that it provides the greatest degree of fairness in assessing control person liability. “Without a narrow interpretation of controlling person liability, it is argued, courts could hold controlling persons liable for any misdeed of its employees, past or present.”¹⁰² The validity of this argument depends largely on how one views social justice. Many feel that those in positions of control are in the best position for bearing the burden of ensuring that lower level employees comply with the securities laws.¹⁰³ Others argue that such a view does not comport with reality because, in large corporations, authority to control is highly fractured, with levels of control so numerous that it would be nearly impossible for a member of upper management to monitor and control the activities of all lower level employees.¹⁰⁴ As such, proponents of the culpable participation test would argue that it is only fair to impose liability on individuals with actual control over the primary violator who somehow participated in the fraud.

B. *Overly Burdensome Pleadings*

Critics of the culpable participation standard might argue that it is unduly harsh because it presents too great a burden on plaintiffs to meet the pleading standard. The PSLRA and Rule 9(b) add to the difficulties faced by plaintiffs by requiring them to plead culpable participation with particularity. This requirement is a heavy burden for plaintiffs, particularly at the pleading stage before discovery is conducted, because plaintiffs have limited access to information within the corporation. As noted above and as is often the case, the evidence needed to plead with particularity is in the sole possession of the defendant(s) and therefore cannot be obtained by the plaintiff except through depositions and discovery.

C. *Overly Broad*

At the other end of the spectrum are the circuits that only require the plaintiff to allege that the defendant occupies a position of control and therefore has the power to control corporate policies. Somewhat akin to a negligence standard,

102. Greco, *supra* note 27, at 177.

103. Carson, *supra* note 2, at 330-31.

104. See Carson, *supra* note 2, at 278. *Accord In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *65-66.

critics argue that the potential control test “begins to resemble insurance” and that it is fundamentally unfair because there is absolutely no examination into whether the defendant had the ability to discover or prevent the violation.¹⁰⁵ In addition, critics point out that this standard does not consider whether the primary violators are managed to the exclusion of others in positions of authority. This would preclude the defendant from exercising any meaningful degree of control, even if the defendant sought such control.¹⁰⁶

D. *Inconsistent Rulings*

Courts applying the more flexible potential control test also tend to produce inconsistent rulings, which makes it difficult for defendants and plaintiffs alike to assess § 20(a) claims.¹⁰⁷ This result is the natural byproduct of the fact-specific inquiry and determination that courts must make under the inexact standards associated with the potential control test. However, allowing the courts to make fact-specific inquiries provides the greatest assurance that those who are truly blameless are more likely to escape liability. Having a blanket rule that offers no flexibility poses a greater risk of individuals being caught in the § 20(a) net who had engaged in no wrongdoing.¹⁰⁸

E. *Omissions/Failures to Act*

Another concern is that the language of the culpable *participation* test requires some degree of active involvement. Such concern would seem harmless until one considers whether a § 20(a) action could exist in the event of a failure to act.¹⁰⁹ If an individual could escape liability under § 20(a) through the failure to act, then that creates an incentive for those in “control” positions to remain ignorant of the corporation’s actions and policies. Greater harm than good would result from officers and directors assuming a willfully ignorant approach to running corporations.

District courts in the Third Circuit are beginning to address this concern. In a recent decision, the district court of Delaware interpreted *Rochez Brothers* to cover omissions, while reconciling

105. See Greco, *supra* note 17, at 188.

106. See Carson, *supra* note 4, at 283-84.

107. See Greco, *supra* note 17, at 190.

108. *Id.* at 190-91.

109. See Carson, *supra* note 2, at 300-01.

it with the culpable participation test.¹¹⁰ The court stated that “the plaintiff must show that the defendant participated in the fraud or furthered the fraud through inaction. Inaction alone cannot be the basis of liability; defendants’ inaction must be deliberate and done intentionally to further the fraud.”¹¹¹ This is still an extremely difficult burden on plaintiffs, but the increased flexibility is a step in a positive direction because the test requires some showing of culpability by the control person while preserving a plaintiff’s ability to base a § 20(a) claim on a failure to act.

F. “Good Faith” and Non-inducement Defense

Section 20(a) has a built-in protection for defendants — the good faith and non-inducement defense. The majority of courts recognize this as an affirmative defense to § 20(a).¹¹² However, most courts that apply the culpable participation test do not recognize this as an affirmative defense.¹¹³ While some culpable participation courts are moving away from that ruling, most still require plaintiffs to allege culpable participation in the pleadings.¹¹⁴

Arguments in support of the potential control test often refer to the affirmative defense. As one scholar noted, “[t]here is no need to restrict unduly the sweep of controlling person status for those with authority to control, in light of the fact that appropriate restriction on their liability can be found within the section’s defense.”¹¹⁵ Thus, the burden is on the defendants to prove that they acted in good faith or did not induce the primary violation. Since the defendants are most likely to be in possession of exculpatory evidence anyway, this would be a more fair allotment of that burden.

IV. PART IV: WHAT STANDARD SHOULD THE COURTS APPLY?

After examining the strengths and weaknesses of each test, the need for a more uniform approach to § 20(a) control person liability is all too apparent. Congress intentionally left “control”

110. *In re Reliance Corp. Sec. Litig.*, 135 F. Supp. 2d 480, 518 (D. Del. 2001) (citing *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 891 (3d Cir. 1975)).

111. *Id.*

112. *See, e.g.*, Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841, 855 n.6 (1993).

113. *See id.*

114. *In re Flag Telecom Holdings, Ltd.*, 308 F. Supp. 2d 249, 273 n.11 (S.D.N.Y. 2004) (quoting *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980)).

115. Carson, *supra* note 2, at 285.

undefined to provide courts with the flexibility to construe the statute in a manner that could evolve over time to adapt to changing corporate transactions.¹¹⁶ This author respectfully submits that courts should utilize that flexibility to adopt a uniform standard whereby 1) the *Metge* test provides two alternative sources to establish “control”; 2) the heightened pleading standards of the PSLRA and Rule 9(b) do not apply to § 20(a) because culpable participation is not an element of § 20(a); and 3) the defendants have an affirmative defense to liability under § 20(a) by showing that they did not act recklessly in failing to prevent the violation.

A. *In re Enron Corporation Securities Litigation & ERISA Litigation*¹¹⁷

The litigation arising from Enron’s collapse provides a useful illustration of a test for control that courts can employ that balances the numerous concerns addressed by this paper. The *Enron Corporation Securities Litigation* arose from the downfall of Enron, an energy company that, at the time of its demise, was the seventh largest corporation in the world.¹¹⁸ The evidence indicates that from 1997 to 2001, Enron used illegal accounting measures and improperly recorded revenue “generated by phony, non-arm’s length transactions with Enron controlled entities” to ensure steady earnings growth, “conceal its growing debt, [and] maintain its artificially high stock prices and investment grade rating.”¹¹⁹

Throughout that time, Arthur Andersen served as Enron’s primary accountant and auditor.¹²⁰ In fact, Enron was Arthur Andersen’s second largest client in terms of revenue generated.¹²¹ Allegedly, Arthur Andersen not only signed off on many of the fraudulent transactions, but also helped Enron officers illegally structure deals to conceal Enron’s true financial condition.¹²² Then, Arthur Andersen allegedly attempted to

116. See, e.g., Nancy C. Staudt, Note, “Controlling” Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts, 72 MINN. L. REV. 930, 937 n.35-36 (1988).

117. *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *65.

118. *NASD Accuses H&R Block Financial Advisors of Fraud*, Nov. 8, 2004, http://www.bloomberg.com/apps/news?pid=10000087&sid=aE_GQi.Z5SJ4&refer=top_world_news.

119. *In re Enron*, 235 F. Supp. 2d at 613.

120. See *id.* at 673-74.

121. See *id.*

122. *Id.*

conceal the fraud by destroying incriminating documents.¹²³

When Enron revealed the massive amount of accounting fraud that had occurred, it immediately collapsed and was forced to declare bankruptcy.¹²⁴ Shareholder litigation quickly followed and, with the corporation bankrupt, plaintiffs pursued claims against the individuals involved.¹²⁵ Based on Arthur Andersen's economic dependence on Enron, its extensive and exclusive involvement in Enron's financial reports, its close relationship with Enron's management, its role in structuring special purpose entities in violation of GAAP, its failure to perform audits in accordance with GAAP, and its certification of Enron's SEC filings, plaintiffs brought primary securities law claims against Arthur Andersen.¹²⁶ With the fraud claims against Arthur Andersen as the predicate underlying claims, plaintiffs also brought suit against individual Arthur Andersen officers and employees in their roles as "controlling persons" under §§ 15 and 20(a).¹²⁷

In 2003, the district court for the Southern District of Texas ruled on a large set of motions to dismiss involving, among other things, claims under § 20(a).¹²⁸ In its ruling, the court clearly divided the responsibilities of the plaintiff and the defendant when bringing a claim under § 20(a)¹²⁹ and made several important findings. First, neither the PSLRA nor Rule 9(b) was deemed to apply to § 20(a) claims, thereby obviating the need for pleading with particularity.¹³⁰ Second, control over the general operations of a corporation was held to be unnecessary to show control under § 20(a).¹³¹ Third, a lower form of culpability called recklessness was determined to be the appropriate standard for determining whether the defendant acted in good faith.¹³²

1. Plaintiffs' Pleading Requirements

(a) Inapplicability of Rule 9(b)

For plaintiffs, the *Enron* case clearly outlined what they

123. *Id.* at 674-75, 684.

124. *See id.* at 637.

125. *See id.* at 565.

126. *Id.* at 673-76.

127. *Id.* at 691.

128. *See In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *3.

129. *See id.* at *32-45.

130. *Id.* at *43.

131. *Id.* at *41-42.

132. *Id.* at *56.

must plead under § 20(a) and the level of specificity with which it must be plead.¹³³ The court first addressed whether Rule 9(b), which requires a plaintiff to plead fraud with particularity,

applies to a § 20(a) claim.¹³⁴ The district court held that it did not and based its ruling on several persuasive arguments.¹³⁵

First, because the Fifth Circuit does not consider culpable participation to be an element of a § 20(a) claim and therefore does not involve a claim of fraud, the application of Rule 9(b) would be misplaced.¹³⁶ Second, the legislative history of the 1933 and 1934 Acts indicates Congress' intent to prevent individuals from evading liability who controlled from "behind the scenes and [had] 'dummies'" commit the violations.¹³⁷ Acknowledging the problems associated with plaintiff's limited access to information during the pre-discovery phase, the court held that requiring the plaintiff to plead with particularity does not comport with congressional intent, because it would be nearly impossible for plaintiffs to succeed.¹³⁸ Finally, the court noted that §§ 15 and 20(a) are interpreted analogously and Rule 9(b) does not apply to § 15.¹³⁹

The court's decision achieves considerable balance in the burdens placed on plaintiffs and defendants. This decision also reflects the growing trend in the law to allow the plaintiffs greater leniency when pleading control.¹⁴⁰ As previously noted, some courts that apply a culpable participation standard have begun to adopt lower pleading standards to allow the cases that would otherwise fail under the heightened standards of Rule 9(b) to survive motions to dismiss.

(b) Control Person Status

As stated, the majority of circuits have adopted the "potential control" test enunciated in *Metge*.¹⁴¹ The *Metge* test required the plaintiff to prove that the defendant "actually participated in (*i.e.* exercised control over) the operations of the

133. See *id.* at *32-42.

134. *Id.* at *42.

135. *Id.* at *55.

136. *Id.* at *43.

137. *Id.* at *44.

138. See *id.*

139. *Id.* at *45.

140. See, e.g., *Freed v. Universal Health Servs.*, No. CIV.A.04-1233, 2005 U.S. Dist. LEXIS 7789, *35 (E.D. Pa. May 3, 2005).

141. See *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *35

corporation in general” and that “the defendant possessed the power to control the specific transaction upon which the primary violation is predicated.”¹⁴² In *Enron*, the court declined to require the first prong of this test.¹⁴³

In deciding only to apply *Metge’s* second prong, the district court was responding to criticism that requiring proof of actual participation in corporate operations simply does not comport with corporate realities.¹⁴⁴ The Court stated that:

[I]t is highly unlikely in a firm as large, complex, and widespread as Arthur Andersen that any single individual would have control of every particular division or engagement. Instead, the Court presumes that decision-making and policy-making powers would have to have been divided and delegated among numerous individuals and groups.¹⁴⁵

To account for that reality, the court held that only those accountants and auditors involved in the Enron engagements and those creating policies that affected Enron, were control persons for purposes of § 20(a).¹⁴⁶ The successful allegations under § 20(a) against lower level employees were those that claimed the defendant was an “essential member” or “significant participant” in the Enron audit.¹⁴⁷

In fact, the court denied just one motion to dismiss where the defendant appeared to lack direct involvement with Enron, either through being in Arthur Andersen’s Houston office or by being assigned to the Enron engagement.¹⁴⁸ In that instance, the individual’s job was essentially as a gatekeeper and he was therefore in a position whereby he should have discovered and prevented the fraud despite a lack of direct involvement with Enron.¹⁴⁹ Consequently, the court was able to separate those

142. *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985).

143. *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *46-47.

144. *See id.* at *65.

145. *Id.*

146. *Id.* at *66.

147. *See id.* at *6 n.4.

148. *See generally id.* at *65-75 (stating the court’s reasoning for granting and denying motions to dismiss).

149. *See generally*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. REV. 301, 302 (2004) (stating defendant William Swanson acted as the Audit Division Head for the Gulf Coast Market Circle and allegedly was aware of the whistleblower allegations).

defendants whose roles did not place them in a position to control or influence the transactions at issue.

There are persuasive incentives for adopting the standard adopted by the district court in *Enron*. By not requiring actual control over the general affairs of the corporation, the court allows for liability against those individuals who (particularly in a highly decentralized entity) do not run the general affairs of the corporation, but possess enough power to control, or have the ability to control smaller transactions, that may nonetheless affect the whole.¹⁵⁰ This also does not exclude the potential defendant who, through his control of the day-to-day operations of the corporation, knew or was reasonably certain to know, or was in a position to prevent, the misconduct.¹⁵¹ As a result, this test prevents those who remain willfully ignorant from escaping liability.¹⁵²

As applied in the *Enron* litigation, the *Metge* test is actually more suitable for proposing two alternative sources of control. This is because it is difficult for an individual who meets the first prong of the *Metge* test to claim (for reasons stated below) that he did not have potential or actual control over the transaction at issue. This provides plaintiffs with more options in pursuing individuals who may not meet both prongs of the *Metge* test, but nonetheless played a role in the fraud. Then, the court may make a determination based on the facts whether or not the defendant acted as a control person. In the *Enron* litigation, this approach provided the most equitable outcome because defendants who were in charge of the specific Enron audits or financial statements were implicated, as well as those officers who may not have been involved in the Enron scandal, but who allowed Arthur Andersen's paper shredding policies to continue.

The primary disadvantage of this approach to determining control is that the test remains very fact-intensive. As a result, it will not cure the problem of inconsistent rulings and the associated uncertainty that plaintiffs and defendants must handle.

2. Defendant's Affirmative Defense Standard

The district court also held that, in order for defendants to assert a good faith defense, they must show that they "used reasonable care to prevent the securities violation, i.e., that [they

150. See *id.* at *69–70.

151. See *id.* at *67–68.

152. See *id.* at *55–56.

were] not reckless.”¹⁵³ To be reckless, a defendant must have “intentionally done an act [including omitting to act] of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences.”¹⁵⁴ Applying this standard, the question becomes “whether the defendant acted recklessly in failing to do what he could have done to prevent the violation.”¹⁵⁵ In the context of controlling person liability, the test would be whether the defendant “was almost certainly aware of the danger.”¹⁵⁶

Such a standard of care is not novel in the § 20(a) context. Indeed, several other circuits apply something akin to a recklessness standard of care to the good faith defense.¹⁵⁷ Although this standard of care may not produce an ideal reconciliation with certain public policy concerns, this standard nonetheless remains the most suitable approach to § 20(a) liability because it satisfies the various concerns that courts consider when interpreting statutory provisions. This includes upholding the legislative history and congressional intent behind the provision, adhering to the context and plain language of the statute, and addressing public policy issues.¹⁵⁸

3. Legislative History

As mentioned above, the legislative history of § 20(a) is nearly non-existent and what little guidance that does exist allows only for conjecture. However, the evidence leads one to surmise that the drafters of the Exchange Act intended § 20(a) to ensnare a more involved and active player in the underlying fraud. Consider the statement of Thomas G. Corcoran, one of the

153. *In re Enron*, 235 F. Supp. 2d at 594 (citing *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. Feb. 1981)).

154. W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* 213 (5th ed. 1984).

155. *G.A. Thompson*, 636 F.2d at 960.

156. *Id.* at 962 n.33 (synthesizing *Sec. & Exch. Comm'n v. Southwest Coal & Energy Co.*, 624 F.2d 1312 (5th Cir. 1980) and *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980)).

157. *See, e.g.*, *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979); *Dellastatious v. Williams*, 242 F.3d 191, 194 (4th Cir. 2001); *Donohoe v. Consol. Operating & Prod. Co.*, 30 F.3d 907, 912 (7th Cir. 1994); *Binder v. Gordian Sec., Inc.*, 742 F. Supp. 663, 668 (N.D. Ga. 1990); *Wheaten v. Mathews Holmquist & Assoc., Inc.*, No. 94C1134, 1996 WL 494245, at *19 (N.D. Ill. Aug 28, 1996). *Cf. Kersh v. Gen. Council of Assemblies of God*, 804 F.2d 546, 550 (9th Cir. 1986) (discussing for whom the liability of culpable participation exists).

158. *See generally Gustafson v. Alloyd*, 513 U.S. 561, 570-71 (1995); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198 (1976).

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principal draftsmen of the Exchange Act, who testified that, “the purpose [of § 20(a)] is to prevent evasion of the provisions of the section [claimed to have been violated] by organizing dummies who will undertake the actual things forbidden by the section.”¹⁵⁹

Similarly, another draftsman referred to “[t]he man who stands behind the scenes and dominates the dummy” as the individual who “ought to be responsible because he is the real party in interest.”¹⁶⁰ While such language does not explicitly reference a particular standard, it does allow for the conclusion that the drafters envisioned an individual aware of the fraud, or at the very least, one who created a situation whereby a fraud *could* occur. Such a scenario is covered by a test that brings individuals who have acted recklessly within the prohibitions of the securities acts.

Notably, although the legislative history may indicate a higher level of involvement than that captured under a negligence theory, there is no evidence that Congress intended to require intentional participation in the primary violation. As some courts have noted, if Congress had intended to require intent, it would have done so explicitly.¹⁶¹ As a result, the district court applied a standard of recklessness involving a level of culpability that falls short of true scienter, but clearly lies above negligence.

4. Context and Language of § 20(a)

Some scholars have noted that the different language used in §§ 15 and 20(a) creates the need for different defense standards. First, § 15 provides for secondary liability for a control person where the predicate claim is violation of §§ 11 or 12, both of which are strict liability provisions. As such, it is sensible to presume that Congress, in imposing strict liability for those provisions, intended to require a higher degree of care (i.e., lack of negligence) “given the centrality of the disclosure of accurate information in distributions to confidence in the capital markets.”¹⁶²

In contrast, § 20(a) encompasses a much broader range of individuals and transactions. Section 20(a) creates liability for a

159. Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of Securities Act*, 53 BUS. LAW. 1, 7 (1997).

160. *Id.* at 8.

161. *In re Enron*, 2003 U.S. Dist. LEXIS 1668, at *56 (citing *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959-60 (5th Cir. Feb. 1981)).

162. Carson, *supra* note 4, at 300.

violation “under any provision of this chapter or of any rule or regulation thereunder.” Because the vast majority of cases brought alleging securities fraud are brought under § 10(b), exposure under § 20(a) is significantly greater.¹⁶³ As a result, the more expansive “liability parameters of § 20(a) have engendered a more broadly worded defense (‘acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action’).”¹⁶⁴ Without the constraints that a reckless standard provides, the amount of litigation that would be brought under § 20(a) would be potentially overwhelming. For these reasons, while negligence may be an appropriate standard for § 15, § 20(a) requires a slightly higher standard.

5. Supreme Court Precedent

In *Ernst & Ernst v. Hochfelder*, the Supreme Court made specific reference to § 20(a) as one of the provisions in the Exchange Act that “contains a state-of-mind condition requiring something more than negligence.”¹⁶⁵ Consequently, several courts hold that § 20(a) requires that the defendant acted with some level of culpability as opposed to negligently.¹⁶⁶ Because this reference was made in dicta, it is not necessarily dispositive of the correct standard of care, but it is certainly persuasive and may indicate how the Supreme Court would rule if a case was ever granted certiorari to resolve the issue.

6. Public Policy Concerns

Finally, and most persuasively in the absence of clear statutory language or congressional intent, there are numerous public policy considerations that weigh in favor of a standard of care that requires some degree of culpability, although not necessarily intentional misconduct.

7. Protects Financial and Legal Industries from Overexposure to Ruinous Litigation

Proponents of a negligence standard for § 20(a)’s affirmative defense argue that a negligence standard provides the greatest opportunity for recovery by injured plaintiffs. While this may be true, Congress evidenced its intent that control person liability

163. Lowenfels & Bromberg, *supra* note 157, at 4.

164. *Id.* at 6.

165. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.28 (1976).

166. *See G.A. Thompson*, 636 F.2d at 959; *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979).

should not amount to a form of insurance.¹⁶⁷ Moreover, the potential exposure this would create could be ruinous to the financial and legal sectors.¹⁶⁸ As witnessed over the past five years, when a corporate scandal breaks the corporation typically seeks bankruptcy protection, thereby forcing plaintiffs to look for other parties against whom they may obtain monetary judgments. Repeatedly, these parties are the accounting firms or lawyers of the corporation.

Given the series of corporate scandals brought to light and the likelihood that many are still to come, the threat of excessive liability for the financial services industry in particular is quite real. As a consequence, any shift in the direction of strict or negligence based liability would result in the collapse of the financial services industry under the weight of insurmountable liability.¹⁶⁹ The collapse of the financial services industry would have disastrous implications for businesses, world economies, and investors. This is a result certainly not intended, and one sought to be prevented, by the federal securities laws.

Most notably, businesses would suffer, as they already do, from the lack of choices available for large audit clients, which has been a recurring concern ever since Arthur Andersen's collapse. In a recent article, *The Wall Street Journal* reflected this growing concern:

Several accounting regulators and senior partners at Big Four accounting firms, none of whom would comment publicly, say they are concerned that one or more firms could be crippled by multiple large judgments. All four of the remaining major firms face large litigation caseloads. A few hundred million dollars in settlement payments in any one year may be manageable.¹⁷⁰

167. The Senate and the House each advanced its version of what standard should govern controlling persons. The Senate proposed an "insurer's liability" standard, while the House opted for a "fiduciary standard" which would impose a duty of due care. S. REP. NO. 73-47, at 5 (1933); H.R. REP. NO. 73-85, at 5 (1933); H.R. REP. NO. 73-152, at 26 (1933). The House version was adopted, indicating that Congress "did not intend anyone to be an insurer against the fraudulent activities of another." *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975).

168. Adrian Michaels & Andrew Parker, *Battle Over Auditors' Protection: UK Action to Provide Shield Could Spur Reform in Other EU States: Moves Designed to Help Corporate Governance by Increasing Pool of Non-Executive Directors*, FINANCIAL TIMES, May 21, 2004, at 1.

169. *Id.*; Beppi Crosariol, *Accountants Call for Reform in Liability Laws*, GLOBE AND MAIL, Sept. 20, 2004 at B12.

170. Jonathan Weil, *Fannie's Dismissal of KPMG Shows Dwindling Choices Among*

This threat becomes even more ominous when one considers that the Big Four accounting firms have an alleged cartel in the supply of audit services to big companies.¹⁷¹

Law firms, and hence potential clients, also stand to be harmed if a standard short of recklessness was adopted. As stated, any shift to a negligence standard would create such heightened exposure that law firms would likely discontinue those services involving securities transactions. This is because either the risk of litigation is too great or the cost of insurance to protect itself from litigation would be too high. Under a cost-benefit analysis, many firms would simply choose to not provide such services and, much like with the auditing industry, the lack of choices would have negative consequences.¹⁷²

Thus, the dilemma is how to strike the delicate balance between excessive liability and an inadequate legal threat.¹⁷³ The costs and risks of litigation associated with gatekeeper services (*i.e.* services that assure proper disclosure to the markets) must not be so great that they cannot be covered by increased fees and insurance coverage, and yet, they must not be so low that there are incentives to take on risky ventures.

Given the risk of being rendered insolvent by a single client, some auditors also might simply cease to offer auditing services, concentrating instead on consulting services or simply on providing bookkeeping services without the provision of any certification. . . . [N]ew entrants would be smaller, risk-preferring “fly-by-night” firms that might seek to charge very high fees for the short term and then liquidate on an adverse judicial determination.¹⁷⁴

In addition, to avoid possible exposure, some accounting firms may choose to be more selective in accepting clients, making it more difficult for public companies to retain auditor

Big Four, WALL ST. J., Dec. 23, 2004, at C1.

171. Michaels & Parker, *supra* note 112, at 1.

172. Interview with James Sottile, Partner, Zuckerman Spaeder LLP, and Charles Mills, Partner, Kirkpatrick & Lockhart LLP (Dec. 2, 2004).

173. See Coffee, *supra* note 117, at 345.

174. *Id.* at 348.

services.¹⁷⁵ Again, these consequences will not benefit corporations, investors, or the public at large.

Lastly, the accounting firms argue that the increased exposure to litigation has already deterred individuals from entering the accounting profession and that it has caused a shift in their duties. In early 2004, a panel consisting of more than fifty people published a report that asserted that “audit firms’ performance has been impaired partly by fear of being sued for billions of dollars by angry investors”.¹⁷⁶ Members of the panel include William McDonough, the new head of the United States accounting regulator (PCAOB), three former heads of the SEC, Robert Hertz, the chief accounting standards-setter, CFOs of companies like Coca-Cola, and other governance and accountancy experts.¹⁷⁷ It noted that, “auditors are afraid of being sued, so we have the absurdity of hundreds of interpretations of a given rule, and the auditors become the rule checkers.”¹⁷⁸

A negligence standard will simply not provide the level of protection necessary to address these concerns. As such, it is beneficial to the health of the economy to provide a higher standard of care. However, adopting a reckless standard avoids providing overly broad protection, which would enable many of the same frauds to reoccur.

Fairly Balances the Interests of Plaintiffs and Defendants

The *Enron* court’s decision achieves the greatest balance of fairness because an intentional misconduct standard would likely trigger the PSLRA or Rule 9(b), while a lower standard (*e.g.* negligence) would open the floodgates of potential litigants.¹⁷⁹ Congress already expressed its desire to curb the overabundance of securities litigation with its enactment of the PSLRA in 1995. It reinforced this intention by not creating a bevy of new private rights of action when it enacted the Sarbanes-Oxley Act in 2002.¹⁸⁰ In addition, the Supreme Court’s ruling in *Central Bank of Denver* indicated a desire by the judiciary to scale back secondary liability.¹⁸¹ Given these congressional and judicial

175. *Id.*

176. David Wighton, *Call for Limit to Legal Liability Among Auditors*, FINANCIAL TIMES, Feb. 25, 2004, at 17.

177. *Id.*

178. Amy S. Butles, *Legal Protection May Improve Quality of Audits, Group Says*, INT’L HERALD TRIBUNE/BLOOMBERG WIRE SERVICES, Feb. 25, 2004.

179. *See supra* Part IV.A.1.

180. Only § 306 (prohibition on insider trading during pension fund blackout period) and § 806 (whistle-blower protection provision) contemplate private rights of action. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 306, 806, 116 Stat. 745, 779, 802.

181. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (holding that § 10(b) liability did not include aider and abettor in private actions).

actions, the reckless standard appears to be the most sensible balance of the opposing interests of plaintiffs and defendants because it does not overly restrict or create new litigation.

8. Includes Omissions/Inaction

Some may argue that a reckless standard would allow too many defendants to escape liability because defendants can show that they did not know of the primary violation through inaction or apathy. However, the Fifth Circuit has expressly stated that, “the burden on the controlling person is to establish that he did not act recklessly in inducing, either by his action or *his inaction*, the act or acts constituting the violation.”¹⁸² As such, the failure to supervise in a non-reckless manner will give rise to § 20(a) liability.

For example, someone in the position of Controller would be unable to assert a defense to § 20(a) if that individual failed to implement a system that would prevent the fraud. Under the reckless standard, that defendant would have to show that he did not know (or was not reckless in not knowing) that such a system should have been implemented. This is an increasingly difficult task in today’s corporate climate. Likewise, a mid-level manager who “looked the other way” by not enforcing company standards would also fail because he would know that his conduct would encourage, allow, or provoke (*i.e.* “induce”) violations, whether or not he knew of the actual violation.

In both scenarios, the absence of effective control person supervision indirectly induced the violations. Shareholders are therefore protected from controlling persons employing inadequate supervisory measures, while control persons are protected from the often unfortunate perfection of hindsight vision.¹⁸³

9. Internal Investigations Provide Early Evidence for Defendants and Ammunition for Plaintiffs

Extensive internal investigations are now regularly being conducted upon any hint of misconduct.¹⁸⁴ As one former federal

182. *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 960 (5th Cir. Feb. 1981) (emphasis added). *See also* *Kersh v. Gen. Council of Assemblies of God*, 804 F.2d 546, 550 (9th Cir. 1986); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 889-90 (3d Cir. 1975).

183. *See Hess v. Am. Physicians Capital, Inc.*, No. 5:04-CV-31, 2005 U.S. Dist. LEXIS 1162 at *6-7 (W.D. Mich. Jan. 11, 2005) (referring to a cause of action involving a § 20(a) claim as one of “fraud by hindsight”).

184. Kathleen Day & Ben White, *When Companies Investigate Themselves*, THE WASHINGTON POST, Dec. 31, 2004, at E01.

prosecutor noted:

Formal, outside, counsel driven investigations have become so much more frequent in the last few years that it just spins your head. It's going on all the time, which is consistent with what you would expect given the new focus that the New York attorney general, the SEC and various U.S. attorneys are putting on white-collar crime in general.¹⁸⁵

An internal investigation involves forming a committee usually composed of independent directors, but increasingly, it is necessary for corporations to obtain outside counsel that will conduct interviews and review documents and procedures to determine if a problem truly exists.

In light of this reality, a reckless standard of care is not overly burdensome on plaintiffs who might otherwise prefer a negligence standard. Shareholders of corporations that conduct internal investigations will generally have access to the investigation's findings. Indeed, lawyers note that "[e]very time you do a report you are creating a road map for the plaintiffs' firms, and there is just nothing you can do about it anymore. They are going to get it and they are going to use it."¹⁸⁶

This corporate reality also means that defendants are in an overwhelmingly advantaged position to gather and produce facts to show they acted in good faith. Consequently, a standard that removes the burden of pleading a good faith defense from defendants (e.g. culpable participation) is unfair. Individuals charged as control persons may access the findings of the internal investigations to carry the burden of asserting an affirmative defense. Considering the availability of this information, the defendants' preexisting "inside" status, and the disadvantaged position of plaintiffs, a standard that would require plaintiffs to show intent is inappropriate because too

Enron-style self-initiated internal investigations have become the tool of choice for corporate directors under siege from charges of wrongdoing at the companies they are supposed to oversee. Boards at Merck & Co., WorldCom Inc., Tyco International Ltd., Adelphia Communications Corp., Riggs Bank, the New York Stock Exchange, Hollinger International Inc. and Freddie Mac all have used them.

Id. In addition, Fannie Mae and AOL/Time Warner utilized internal investigations to detect corporate fraud. *Id.*

185. *Id.* (quoting Jonathan D. Polkes, Partner in the business fraud and complex litigation practice at Cadwalader, Wickersham & Taft, LLP).

186. *Id.* (quoting Polkes).

many plaintiffs would be unable to survive a motion to dismiss, and therefore be deprived of any redress.

10. Plaintiffs Maintain Other Avenues for Redress

While a reckless standard may close the door on a higher number of plaintiffs, it is important to note that foreclosure of a § 20(a) claim does not mean that plaintiffs lack other means for redress. For example, plaintiffs may pursue state law claims against defendants. Most state law claims involve violations of the state's corporation laws, which may include damages for breaches of the controlling person's fiduciary duties. Of course, many plaintiffs may prefer to bring suit under federal law, but it is nonetheless an alternate avenue for injured parties.

Plaintiffs may also have an action under § 552 of the Restatement (Second) of Torts for negligent misrepresentation.¹⁸⁷ Section 552 "permits plaintiffs who are not parties to a contract for professional services to recover from the contracting professionals" and "imposes a duty to avoid negligent misrepresentation irrespective of privity."¹⁸⁸ Courts generally permit § 552's application in securities actions.¹⁸⁹

Plaintiffs may also utilize common law agency principles to impose secondary liability.¹⁹⁰ The theory of respondeat superior, in particular, is available in several circuits in the context of securities actions.¹⁹¹ It must be acknowledged that 1) this does

187. See generally RESTATEMENT (SECOND) OF TORTS § 552 (1977).

188. *In re Enron*, 235 F. Supp. 2d at 607 (quoting *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787, 792 (Tex. 1999)).

189. See *In re Enron*, 235 F. Supp. 2d at 607.

190. There are three agency principles: (1) if the company "actually" authorized the tortious conduct of the agent; (2) if it appears that the agent has "apparent authority" to commit the tortious conduct; and (3) if the agent has "inherent agency powers," commonly known as the doctrine of respondeat superior. Because companies rarely actually authorize their employees to commit securities fraud, the latter two principles are more pertinent to securities litigation. Courts have been split on which one to apply.

Peri Nielson & Claudia Main, *Company Liability after the Sarbanes-Oxley Act*, INSIGHTS, Oct. 2004, at 2-3.

191. The First, Second, Fifth, Sixth, Eighth, and Ninth Circuits have held that the securities acts do not preclude secondary liability under respondeat superior. *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 383-84 (5th Cir. 2004); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-77 (9th Cir. 1990) (en banc); *In re Atlantic Fin. Mgmt., Inc.*, 784 F.2d 29, 35 (1st Cir. 1986); *Marbury Mgmt. Inc. v. Kohn*, 629 F.2d 705, 712, 716 (2d Cir. 1980); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *Holloway v. Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976). The Third Circuit has reached the opposite conclusion, *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975), while the Fourth Circuit law has been described by the 9th Circuit as "in a state of confusion." *Hollinger*, 914 F.2d at 1576 n.27 (*Compare Carras v. Burns*, 516 F.2d 251, 259-61 (4th Cir. 1975) with *Carpenter v Harris, Upham & Co.*, 594

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not resolve the problem that most corporations are bankrupt and 2) the controlling person provision allows plaintiffs to go outside of who would normally be caught within the walls of common law agency principles. Some circuits hold that the proper construct for the securities laws is: primary liability for the employee, respondeat superior liability for the employer, and then “control person” liability for anybody who could not be reached by respondeat superior. This creates an obstacle for many plaintiffs where the corporation is bankrupt.¹⁹²

That obstacle may prove to pose far fewer problems to plaintiffs because of § 308 of Sarbanes-Oxley. Section 308 allows the SEC to establish a “Fair Fund” in enforcement actions.¹⁹³ Fair funds are accounts into which penalties or fines are paid into as opposed to being paid to the U.S. Treasury.¹⁹⁴ Fair funds are established whenever there is a disgorgement penalty.¹⁹⁵ The penalty is then held to reimburse injured investors for the corporation’s misconduct.¹⁹⁶ Distribution of the funds presently held in these accounts have, in many cases, not yet reached investors, but it is hopefully a mere matter of time.¹⁹⁷

11. The Deterrent Effect of the Securities Laws is not Reduced

A reckless standard of care will not provide controlling persons with so much protection from liability that it will decrease the deterrence value of § 20(a). It is necessary to encourage more extensive involvement by management while deterring complacency and “dummy directors.” Investors are currently protected from such conduct through the new demands imposed on officers, directors, and management under the

F.2d 388, 394 (4th Cir. 1979)).

192. Cf. Nielson, *supra* 133, at 4 (explaining that the financial costs to rectify a wrong doing are devastating for companies).

193. 15 U.S.C. § 7246(a) (Supp II. 2002).

194. *Id.*

195. *Id.*

196. For example, Qwest, in part due to its deteriorating financial conditions, will place \$250 million into a fair fund as part of its settlement with the SEC. As of September 2004, the fair fund for WorldCom’s investors totaled \$684 million (of \$750 million due) while Enron investor’s fair fund has amassed \$432 million. See Jonathan Peterson, *Fair Funds’ Give Investors Recourse*, L.A. TIMES, Sept. 27, 2004, at C1; News Release, U.S. Dep’t of Justice, Fact Sheet of Second Year of President Bush Corporate Fraud Task Force (July 20, 2004), available at 2004 WL 1621161.

197. See, e.g., Michael J. Martinez, *Defrauded Investors Await Money, Lawyers Collect Enron, WorldCom Class-action Settlements, Work on Distribution Plans*, AKRON BEACON J., July 14, 2005, at D1 (mentioning that settlement money to be distributed to investors is being held in an account pursuant to the “Fair Fund”).

Sarbanes-Oxley Act.¹⁹⁸ For instance, if officers, directors, or management takes a “hands-off” approach in corporate dealings, there is a strong likelihood that the corporation’s auditor will not sign-off on its disclosure or internal controls as is now required under § 404 of Sarbanes-Oxley.

Likewise, the CEO and CFO would be equally hesitant to certify periodic reports under §§ 302 and 906 of Sarbanes-Oxley. When Congress enacted the Sarbanes-Oxley Act in July of 2002, President Bush stated that:

My accountability plan . . . requires CEO’s to personally vouch for their firm’s annual financial statements. Currently, a CEO signs a nominal certificate and does so merely on behalf of the company. In the future, the signature of the CEO should also be his or her personal certification of the veracity and fairness of the financial disclosures.¹⁹⁹

Interpreting the legislative intent of § 302, the SEC states in the rules that certification means that the officer has weighed the appropriateness of utilized accounting policies and whether the corporation properly applied those accounting policies.²⁰⁰ The officer must consider if the disclosure of financial information is informative and reasonably reflects the underlying transactions and events and whether any additional disclosures are necessary to provide investors with a materially accurate assessment of an issuer’s financial condition, results of operations and cash flows.²⁰¹ Complying with GAAP alone may not be sufficient.²⁰²

The impact of these increased standards is that it makes it difficult, if not impossible, (without incurring other liability) for a particular officer to claim that he did not have the power to influence or control what was being said in those filings. The same should hold true for audit committee members who certify

198. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified as amended at 15 U.S.C.A. § 7245 (West 2005)).

199. Fairfax, *supra* note 13, at 15 (citing Pres. Bush’s Speech on Corporate Responsibility, July 9, 2002, available at http://www.pbs.org/newshour/bb/business/july-dec02/bush_7-9.html (last visited Oct 1, 2005)).

200. Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. 57,276, 57,279 (Sept. 9, 2002).

201. See *id.*

202. “Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws.” *Id.* at 57, 279 n.55.

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the financial statements. The degree of impact, however, greatly depends on the test of control that a jurisdiction applies. For the jurisdictions allowing actual control over the general operations of the corporation and/or the fraudulent transaction to create liability, it will be harder for defendants to argue lack of knowledge. Because of the certification requirement, a pleading alleging defendant's certification should, likewise, be given more weight in light of the increased responsibilities associated with certification.²⁰³

The heightened expectations and demands now placed on officers, directors, employees, auditors, and lawyers in the securities arena, in addition to the federal securities laws already in place, provides the framework to ensure the attentive and watchful exercise of control within a corporation. Sarbanes-Oxley's increased sentencing for corporations and individuals, along with the Department of Justice's fervor in imposing criminal sanctions on violators, provides additional deterrence value.²⁰⁴ These two factors working together provide the necessary motivation and framework for compliance while decreasing an individual's ability to claim that he did not know, or that he was not reckless in not knowing, of the misconduct.

V. CONCLUSION

Given the extraordinary variations in determining § 20(a) liability, the circuits would benefit from a uniform standard that remedies the deficiencies of the various tests while adopting the positive aspects.²⁰⁵ While there is no perfect solution that will

203. See *New Jersey v. Sprint Corp.*, 314 F. Supp. 2d 1119, 1144 (D. Kan. 2004) (holding that at the pleading stage, plaintiffs enjoyed an inference of control against directors who signed the SEC filings because "an allegation that a board member signed an SEC filing that contains a misleading or fraudulent statement can raise a sufficient inference of control because it comports 'with common sense to presume that a person who signs his name to a report has some measure of control over those who write the report.'") (citations omitted).

204. See *e.g.*, SOLOMON WISENBERG, NEW CRIMINAL STATUTES AND PENALTIES UNDER THE SARBANES-OXLEY ACT OF 2002, http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/03spring/36/new_criminal.pdf (last visited Nov. 22, 2005).

205. At present, the circuits that currently espouse the culpable participation theory of control are best suited towards moving to the Fifth Circuit standard, as those courts are shifting away from the culpable participation test's undue harshness and appear to be seeking a better balance of interests. See *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 23 (D.D.C. 2000) (contrasting the culpable participation test and the Fifth Circuit standard). Those circuits that have firmly adopted the *Metge* test are least likely to adopt the Fifth Circuit control test, but the opportunity still exists for those courts to implement a uniform standard of care for the affirmative defense. In fact, the Seventh Circuit has already done this. See *Donohoe v. Consol. Operating & Prod. Corp.*, 30 F.3d 907, 911-12 (7th Cir. 1994).

satisfy all, the need for certainty in the law requires adopting the best solution in light of the factors discussed above.²⁰⁶ In lieu of more specific guidance from Congress or the Supreme Court, the *Enron* court successfully presents an acceptable standard for imposing control person liability. The Fifth Circuit's control test and good faith standard of care manage to strike the delicate balance of plaintiffs' and defendants' interests under § 20(a). The court remains mindful of congressional intent, the context and language of the statute, and the numerous public policy concerns that are becoming exceedingly necessary to address. As this issue is sure to be increasingly litigated in the wake of so many corporate scandals, it will be interesting to see if § 20(a) standards evolve to reflect these developing concerns.

206. As the Supreme Court noted in its decision abolishing secondary liability under the aider and abettor theory, the courts want to avoid "the undesirable result of decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 188 (1994).