
Let's Be Frank: The Future Direction of Controlling Person Liability Remains Uncertain

“The explicit authority under Dodd-Frank to use control person liability under the Exchange Act may encourage further expansion of this theory of liability to attempt to cover those who are simply ‘around’ a violation or where a violation occurs within their chain of command.”¹

I. INTRODUCTION

In the wake of the Great Depression, Congress enacted the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act).² Together, the Acts provide the Securities and Exchange Commission (SEC) with broad authority over the securities industry, and institute methods for holding those who commit securities fraud liable.³ Section 15 of the 1933 Act and section 20(a) of the 1934 Act establish controlling person liability, a mechanism for establishing secondary liability against corporate directors and officers for securities fraud committed by their subordinates.⁴ Section 15 of the 1933 Act merely permits controlling person liability to be pursued if very limited types of securities fraud have been committed.⁵ As a result, pursuing a controlling person liability claim under section 20(a) of the 1934 Act has historically been both the SEC and private litigants’ preferred course of action as it broadly allows for secondary liability to be attached to any underlying

1. Bruce Hiler & Sharon Rose, *Expansion of the U.S. SEC’s Enforcement Powers Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 17 World Sec. L. Rep. (BNA) 3 (Jan. 2011), available at <http://www.cadwalader.com/assets/article/011711HilerRoseWorldSecuritiesLawReport.pdf>.

2. See 1 LOUIS LOSS, *SECURITIES REGULATION* 120-21 (2d ed. 1961) (describing effects of Great Depression on implementation of 1933 and 1934 Acts); see also Laura Greco, Note, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 169 (1999) (providing intent of Congress to prevent recurrence of event similar to Great Depression).

3. See *The Laws That Govern the Securities Industry*, SEC, <http://www.sec.gov/about/laws.shtml> (last modified Aug. 30, 2012) (providing description and purpose of 1933 and 1934 Acts).

4. See *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (describing section 20(a) controlling person liability’s use as enforcement mechanism).

5. See 15 U.S.C. § 77o (2006 & Supp. V 2011) (providing 1933 Act section 15 controlling person liability). Section 15 controlling person liability is extremely narrow because controlling persons can only be held jointly and severally liable if they control persons liable under sections 77k or 77l of the 1933 Act, which pertain to civil liability for false registration statements and for both prospectuses and communications respectively. *Id.*; see also 15 U.S.C. § 77k (2006) (discussing civil liabilities in connection with false registration statements); 15 U.S.C. § 77l (2006) (regarding civil liabilities in connection with prospectuses and communications).

security claim within the Act.⁶

While drafting both Acts, Congress consciously refrained from defining the term “control” because it believed that courts could effectively apply the term depending on the given facts of a case.⁷ Therefore, varying standards of controlling person liability have evolved throughout the judicial system, including within federal circuit and district courts.⁸ Recently, in continuing efforts to protect investors, Congress has enacted a substantial piece of legislation that may help shed light on the inconsistent application of controlling person liability: the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).⁹

In recent history, circuit courts have been split as to whether the SEC has authority to utilize 1934 Act section 20(a) controlling person liability within its enforcement actions.¹⁰ Section 929P(c) of Dodd-Frank addresses this issue, clarifying that the SEC has authority to bring actions founded on section 20(a) controlling person liability.¹¹ Nevertheless, the controlling person liability issue may remain at the forefront of securities litigation as the SEC seeks to hold corporate officers and directors secondarily liable under section 20(a).¹²

This Note examines Dodd-Frank’s potential effect on the current state of the law regarding controlling person liability.¹³ Part II.A provides a review of the legislative history of the 1933 and 1934 Acts and their respective controlling person liability sections.¹⁴ Part II.B discusses the varying judicial interpretations and confusion surrounding sections 15 and 20(a) controlling

6. See 15 U.S.C. § 78t (2006 & Supp. V 2011) (providing controlling person liability pursuant to section 20(a) of 1934 Act). Section 20(a) of the 1934 Act is much broader than the controlling person liability established under the 1933 Act, as it allows for joint and several liability to attach to any person found liable “under any provision of this chapter or of any rule or regulation thereunder.” *Id.* § 78t(a).

7. See 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, 938-39 (1988) (describing congressional purpose for not defining control); see also § 77o (defining controlling persons while failing to define control); § 78t (failing to define control).

8. See *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 414 (S.D.N.Y. 2003) (describing lack of clarity surrounding controlling person liability standard). The phrase “culpable participation” is at the root of the confusion regarding the proper standard to apply when pleading controlling person liability. *Id.*

9. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(c), 124 Stat. 1376, 1865 (2010) (expressly providing SEC with power to bring controlling person liability enforcement actions).

10. See *infra* notes 100-03 and accompanying text (discussing various interpretations as to whether SEC can bring controlling person liability enforcement actions).

11. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(c) (providing SEC with express authority to bring enforcement actions regarding controlling persons liability); see also Hiler & Rose, *supra* note 1, at 3 (discussing SEC’s power to bring actions under section 20(a) pursuant to 929P(c) of Dodd-Frank).

12. See Hiler & Rose, *supra* note 1, at 3-4 (considering potential for SEC to question wider range of conduct under section 929P(c) of Dodd-Frank).

13. See *infra* Part III.B (discussing Dodd-Frank and SEC’s potential yearning to utilize potential influence standard).

14. See *infra* Part II.A (discussing legislative history regarding controlling person liability).

person liability.¹⁵ Part II.C discusses both the implementation of Dodd-Frank and prior inconsistent views as to whether the SEC has the power to bring controlling person liability actions pursuant to section 20(a).¹⁶ Finally, Part III examines the two controlling person liability standards—culpable participation and potential control—and suggests which of the two the SEC would likely find more equitable.¹⁷

II. HISTORY

A. Statutory History of Controlling Person Liability

In response to the stock market crash of October 1929, Congress adopted the Securities Act of 1933 and the Securities Exchange Act of 1934.¹⁸ Although the two acts serve the same general purpose—to discourage fraud and provide investors with adequate information—they regulate different activities within the securities market.¹⁹ The 1933 Act primarily concerns the initial distribution process of securities, requiring entities seeking to issue securities to provide specific information to potential purchasers and the SEC.²⁰ In contrast, the 1934 Act created the SEC for the basic purposes of regulating the securities markets and affording remedies for fraud in securities trading.²¹

The 1933 and 1934 Acts provide investors with legal recourse against persons who are primarily liable under the Acts, but Congress also expressly provided for secondary liability through the creation of section 15 of the 1933

15. See *infra* Part II.B (describing various standards of controlling person liability).

16. See *infra* Part II.C.

17. See *infra* Part III.

18. See LOSS, *supra* note 2, at 120-21 (describing Great Depression's financial impact on United States). On March 29, 1933, President Roosevelt urged Congress to enact a law on the issuance of securities. *Id.* at 121. Shortly thereafter, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Banking Act of 1933 were adopted. *Id.*

19. See *id.* at 123 (detailing philosophy of enactment); see also Staudt, *supra* note 7, at 934 (providing historical motive for implementation of 1933 and 1934 Acts).

20. See LOSS, *supra* note 2, at 130 (outlining general purposes of 1933 Act); see also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (describing purpose of 1933 Act). The Securities Act of 1933 “was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.” *Hochfelder*, 425 U.S. at 195.

21. See LOSS, *supra* note 2, at 130-31 (outlining general purposes of 1934 Act). No security may be listed on a stock exchange without having been registered with the SEC and the exchange. *Id.* at 131. The 1934 Act requires similar information to that which is required under the 1933 Act for disclosure. *Id.*; see also *Hochfelder*, 425 U.S. at 195 (describing intended purpose for implementation of 1934 Act). The Supreme Court stated: “The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.” *Hochfelder*, 425 U.S. at 195. In order to effectuate this remedial purpose, Congress provided the SEC with numerous flexible enforcement powers. *Id.* The Supreme Court also recognized the need to interpret the 1934 Act flexibly, rather than restrictively, in order for the SEC to properly effectuate its remedial purposes. See *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (providing proper manner to interpret 1934 Act).

Act and section 20(a) of the 1934 Act controlling person liability.²² One of Congress's primary motives for providing secondary liability in the form of the controlling person provisions was to curb corporate directors from using "dummies"—employees who commit fraud at the direction of their superiors—in an effort to avoid liability.²³ A secondary violator of the securities statutes or rules either supports or assists the primary violator, or can be found liable simply due to his or her relationship with the violator.²⁴ Conversely, primary violators of the securities laws personally commit the act prohibited by rule or statute; however, especially in modern complex securities markets, violations rarely occur in such a simple manner.²⁵ Because Congress expressly provided for secondary liability in section 15 of the 1933 Act and section 20(a) of the 1934 Act, controlling person liability is the sole means of holding secondary security violators liable in private actions.²⁶

Section 15 of the 1933 Act provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.²⁷

22. See Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 1-2 (1997) (stating Congress did not overlook secondary liability when creating 1934 Act).

23. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990) (describing Congress's intent to deter organization of dummies from committing forbidden actions); see also Lowenfels & Bromberg, *supra* note 22, at 7-8 (stating congressional purpose for implementing 1934 Act section 20(a) and 1933 Act section 15); Staudt, *supra* note 7, at 936-37 (analyzing congressional concern of corporate directors attempts to escape liability).

24. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 755 (6th ed. 2009) (describing secondary liability).

25. See *id.* (illustrating securities fraud liability); see also Lowenfels & Bromberg, *supra* note 22, at 1 (stating Congress did not overlook secondary liability when creating 1934 Act).

26. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994) (stating Congress did not intend tort aiding and abetting principles to apply to securities law). In *Central Bank of Denver*, the Supreme Court eliminated securities private rights of action against aiders and abettors, reasoning that Congress intended controlling person liability under section 20(a) of the 1934 Act to provide for secondary liability. *Id.* The Court stated: "The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere." *Id.*; see also *Pinter v. Dahl*, 486 U.S. 622, 650 (1988) (stating Congress had little trouble creating secondary liability).

27. 15 U.S.C. § 77o(a) (2006 & Supp. V 2011).

Further, section 20(a) of the 1934 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 or cause of action.²⁸

Each section provides controlling persons with an affirmative defense.²⁹ Nevertheless, despite varying language, courts often interpret section 15 of the 1933 Act and section 20(a) of the 1934 Act interchangeably.³⁰

When drafting the controlling person provisions of the 1933 and 1934 Acts, Congress believed it undesirable to define the term “control,” opting to allow courts to define it on a case-by-case basis.³¹ As a result, the meaning of controlling persons and the application of its affirmative defense remains uncertain.³² Seeking guidance, courts often look to the definition of control provided by the SEC.³³ The SEC defines 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

28. *Id.* § 78t(a).

29. Compare § 77o(a) (providing affirmative defense based on lack of knowledge), with § 78t(a) (providing good faith affirmative defense). Section 15 of the 1933 Act holds a controlling person jointly and severally liable to the same extent as the controlled person, “unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.” § 77o(a). Conversely, section 20(a) of the 1934 Act holds controlling persons jointly and severally liable to the same extent as the controlled person, “unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.” § 78t(a).

30. See, e.g., *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 n.7 (10th Cir. 1998) (articulating both sections interpreted similarly); *Farley v. Henson*, 11 F.3d 827, 835 (8th Cir. 1993) (describing same analysis applies to both statutory provisions); *In re Asia Pulp & Paper Sec. Litig.*, 293 F. Supp. 2d 391, 395 (S.D.N.Y. 2003) (stating both provisions interpreted in same manner).

31. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1580 n.4 (9th Cir. 1990) (Hall, J., dissenting) (stating Congress’s conscious decision to refrain from defining control). Speaker of the U.S. House of Representatives, Sam Rayburn, stated the term “control” was intended to encapsulate actual and legally enforceable control. *Id.* While expressing his belief that defining control would be nearly impossible, Mr. Rayburn provided multiple examples of methods of control, including “stock ownership, lease, contract, and agency.” *Id.* (internal citations omitted).

32. See COX ET AL., supra note 24, at 773-74 (describing inconsistencies between affirmative defenses and undefined nature of control); see also *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1441 n.9 (9th Cir. 1987) (illustrating section 20(a)’s lack of clarity). The court in *Wool* emphasized Congress’s failure to define the scope and degree of control of the controlling person over the subordinate. *Wool*, 818 F.2d at 1441 n.9.

33. See, e.g., *Sheinkopf v. Stone*, 927 F.2d 1259, 1270 (1st Cir. 1991) (quoting SEC definition of control); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981) (citing SEC’s standard for controlling person); *Pharo v. Smith*, 621 F.2d 656, 670 (5th Cir. 1980) (consulting SEC’s definition of control).

contract, or otherwise.”³⁴ Despite the SEC’s definition of control, some courts interpret what constitutes control in their own capacity.³⁵

B. Varying Judicial Interpretations of Controlling Person Liability

1. Potential Influence Standard

Due to section 20(a) of the 1934 Act’s broader liability purview, affirmative defense, and application to both the 1934 Act’s 10(b) antifraud provision and Rule 10b-5, it is litigated more frequently than section 15 of the 1933 Act.³⁶ When determining whether a defendant is a controlling person, most circuits apply the two-part analysis developed by the Eighth Circuit in *Metge v. Baehler*.³⁷ Commonly referred to as the potential influence test, courts generally focus on whether the defendant had the potential to, or actually did, control the primary violator.³⁸ In order to label the defendant as a controlling person, the potential influence test requires the plaintiff to prove that the

34. 17 C.F.R. § 230.405 (2012) (providing definition of control); *see also* Greco, *supra* note 2, at 172-73 (outlining SEC definition of control and judicial interpretations).

35. *See* Staudt, *supra* note 7, at 940 n.51 (stating courts acknowledge SEC’s interpretation of control but do not rely upon it); *see also* Greco, *supra* note 2, at 173 (noting most courts ignore SEC’s definition of control and find alternative reasoning).

36. *See* Lowenfels & Bromberg, *supra* note 22, at 3-6 (describing differences between controlling person provisions). The 1934 Act’s section 20(a) imposes secondary liability on violators of the 1934 Act’s section 10(b) and SEC Rule 10b-5, which are both highly litigated antifraud provisions. *Id.* at 4; *see also* 15 U.S.C. § 78j(b) (2006 & Supp. V 2011) (providing widely litigated 1934 Act antifraud provision 10(b)). The 1934 Act’s section states: “It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . [or] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.” § 78j(b). SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (2012).

37. 762 F.2d 621, 630-31 (8th Cir. 1985) (requiring plaintiff prove defendant actually participated in operations and possessed power to control specific transaction). The Eighth Circuit reasoned that “[t]he [controlling person liability] statute is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a ‘controlling person’ liable.” *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967) (discussing manner in which 1934 Act section 20(a) should be construed); *see also Metge*, 762 F.2d at 630-31 (discussing two-part analysis for controlling person liability statute); COX ET AL., *supra* note 24, at 777 (quoting *Metge v. Baehler*).

38. *See, e.g.,* *Rochez Bros. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975) (explaining judicial consideration of defendants’ potential power to influence or control person’s activities); *City of Painesville v. First Montauk Fin., Corp.*, 178 F.R.D. 180, 192 (N.D. Ohio 1998); *Lazzaro v. Manber*, 701 F. Supp. 353, 368 (E.D.N.Y. 1988) (describing courts’ focus on potential power to control as opposed to actual exercise of control).

defendant “actually participated in . . . the operations of the corporation in general . . . [and] that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this latter power was exercised.”³⁹

The Sixth Circuit closely follows the Eighth Circuit’s potential influence test established in *Metge*.⁴⁰ In *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, the Sixth Circuit found it unnecessary to choose between the different tests established in other circuits.⁴¹ Nonetheless, Senior Circuit Judge Engel ultimately applied the two-part *Metge* analysis because it is the least rigorous of the controlling person standards.⁴² Ultimately, the plaintiff failed to establish that the defendant met the first prong of the test because he did not demonstrate that the defendant actually exercised control over the operations of the business entity.⁴³

As evidenced in *Harrison v. Dean Witter Reynolds, Inc.*,⁴⁴ the Seventh Circuit has also elected to apply the potential influence test provided by the Eighth Circuit in *Metge*.⁴⁵ Unlike many of the other circuits, the Seventh expressly rejected the minority culpable participation standard—a stricter standard requiring plaintiffs to show that the controlling person was a culpable participant in the underlying securities fraud.⁴⁶ The Seventh Circuit established that the concept of control almost always means the ability to “direct the

39. *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984), *aff'd in part, rev'd in part*, 762 F.2d 621 (8th Cir. 1985); *see also Metge*, 762 F.2d at 631 (outlining potential control test).

40. *See* PR Diamonds, Inc. v. Chandler, 91 F. App'x 418, 441 (6th Cir. 2004) (providing two requirements for holding controlling person liable); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 486 (6th Cir. 1992) (applying *Metge*'s two-prong test); *see also* Erin L. Massey, *Control Person Liability Under Section 20(a): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 118-22 (2005) (noting Sixth Circuit's adoption of Eighth Circuit's *Metge* standard).

41. *See Sanders Confectionery Prods., Inc.*, 973 F.2d at 486 (noting plaintiff's complaint failed to meet either controlling person liability standard). Prior to 1992, the Sixth Circuit had not adopted a test for establishing controlling person liability. *See id.* The court found it “unnecessary to choose between the various [controlling person liability] tests . . . because [the plaintiff] failed to plead sufficient acts of control under the least rigorous standard applied in *Metge*.” *Id.*

42. *See id.* (describing *Metge* standard as least rigorous of controlling person liability standards).

43. *See id.* (providing court's analysis). The Sixth Circuit reasoned that because the defendant participated in such narrow capacity within the corporation, he did not meet the first prong of the potential influence standard because he did not actually participate in the operations of the business entity. *See id.*

44. 974 F.2d 873 (7th Cir. 1992).

45. *See id.* at 880-81 (stating district court erred in application of narrow controlling person liability standard).

46. *See id.* at 881 (rejecting culpable participation standard); *see also* *Donohoe v. Consol. Operating & Prod. Corp.*, 982 F.2d 1130, 1138 n.7 (7th Cir. 1992) (expressly acknowledging prior rejection of culpable participation standard). In *Harrison*, the Seventh Circuit noted that the circuit has never approved the culpable participation test or any other test that would significantly limit the definition of a controlling person. *See Harrison*, 974 F.2d at 880 (rejecting lower court's application of culpable participation standard). Conversely, the Seventh Circuit has adopted a standard that “greatly expands Section 20(a)'s circle of liability.” *Id.*; *see also* Massey, *supra* note 40, at 119 (describing Seventh Circuit's application of potential influence test).

actions of the people who issue or sell the securities.”⁴⁷ The court reasoned that the culpable participation standard defied Congress’s intent by allowing corporate officers to avoid controlling person liability by remaining ignorant of their subordinates’ fraudulent conduct.⁴⁸

Initially, the Ninth Circuit adhered to a strict culpable participation standard.⁴⁹ The court in *Buhler v. Audio Leasing Corp.*⁵⁰ required a finding that the defendant had actual influence or power over the subordinate violator and that the defendant culpably participated in the securities violation.⁵¹ Over time, however, the Ninth Circuit moved toward utilizing a potential influence test.⁵² In *Hollinger v. Titan Capital Corp.*, the court disagreed with prior Ninth Circuit decisions and held that in the context of broker-dealers, a plaintiff is not required to show culpable participation.⁵³ The court reasoned that the plaintiff’s burden of showing culpable participation was beyond the purview of Congress’s intent in drafting section 20(a) of the 1934 Act.⁵⁴ Basing its reasoning on the language of the statute, the Ninth Circuit believed that requiring the plaintiff to show the defendant’s culpable participation was ill-conceived and held that the defendant should bear the burden of proving his good faith.⁵⁵

According to *Brown v. Enstar Group, Inc.*,⁵⁶ the Eleventh Circuit holds a controlling person liable if he had the power to control the general affairs of the corporation at the time of the violation, he was able to directly or indirectly control or influence the policy that resulted in the primary liability, and it can be established that the controlled person violated securities laws.⁵⁷ The court

47. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986) (defining control for purposes of section 20(a) or section 15 claims).

48. *See Donohoe*, 982 F.2d at 1138 (critiquing SEC’s definition of control); *see also Massey, supra* note 40, at 119 (providing Seventh Circuit’s reasoning for utilizing potential influence test).

49. *See Kersh v. Gen. Council of Assemblies of God*, 804 F.2d 546, 549 (9th Cir. 1986) (describing prima facie case for controlling person liability); *see also Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978) (requiring participation by controlling person).

50. 807 F.2d 833 (9th Cir. 1987).

51. *See id.* at 835 (outlining culpable participation test for controlling person liability).

52. *See Greco, supra* note 2, at 184 (describing Ninth Circuit’s departure from culpable participation test); *see also Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990) (holding plaintiff not required to show culpable participation).

53. *See Hollinger*, 914 F.2d at 1575 (holding culpable participation in broker-dealer context not required to establish 20(a) controlling person liability); *see also Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1161 (9th Cir. 1996) (acknowledging plaintiff need not prove defendant’s culpable participation in alleged violation).

54. *See Hollinger*, 914 F.2d at 1575 (describing court’s reasoning for utilizing potential influence standard). The court reasoned that liability can only be determined through the establishment of a control relationship with the primary violator, and such liability is then subject to the defense of good faith. *See id.*

55. *See id.* (interpreting section 20(a) and placing burden of proof regarding good faith defense on defendant). The Ninth Circuit opined that “the statute premises liability solely on the control relationship, subject to the [defendant’s] good faith defense.” *Id.*

56. 84 F.3d 393 (11th Cir. 1996).

57. *See id.* at 396-97 (providing Eleventh Circuit’s standard for controlling person liability).

arrived at this test through the combination of two prior requirements provided in the Fifth Circuit cases of *Pharo v. Smith*⁵⁸ and *G.A. Thompson & Co. v. Partridge*.⁵⁹ At first glance, the Eleventh Circuit standard appears substantially similar to the Eighth Circuit's *Metge* analysis; however, there is an important distinction.⁶⁰ In *Brown*, the Eleventh Circuit conceded that it is yet to decide the meaning of "power to control," whereas the Eighth Circuit in *Metge* established that the plaintiff must prove that the defendant actually exercised power over the entity primarily liable.⁶¹

In *G.A. Thompson & Co.*, the Fifth Circuit expressly rejected the culpable participation standard for controlling person liability.⁶² Nevertheless, in *Dennis v. General Imaging, Inc.*,⁶³ the Fifth Circuit appeared to require the plaintiff to prove culpable participation.⁶⁴ Three years later, in *Abbott v. Equity Group, Inc.*, the court expressed its discontent with *Dennis*, stating that the holding failed to reflect the circuit's rejection of the culpable participation requirement articulated in *G.A. Thompson & Co.*⁶⁵ Although making reference to the inconsistency within the Fifth Circuit, the *Abbott* court found no reason to resolve the issue within the confines of the facts of the case at hand.⁶⁶ As a result, the Fifth Circuit appears to apply the potential influence test, notwithstanding the exception of the culpable participation test applied in *Dennis*.⁶⁷

The Tenth Circuit has also expressly rejected the use of the culpable

58. 621 F.2d 656, 670 (5th Cir.), *rev'd in part*, 625 F.2d 1226 (5th Cir. 1980).

59. 636 F.2d 945, 958 (5th Cir. 1981); *see Brown*, 84 F.3d at 396 (describing combination of factors provided in *Pharo* and *G.A. Thompson & Co.*). In *Pharo*, the Fifth Circuit required a finding of power to control management or the company in general. *See* 621 F.2d at 670. Moreover, in *G.A. Thompson & Co.*, the court required the defendant to exemplify "the requisite power to directly or indirectly control or influence corporate policy." 636 F.2d at 958; *see also Greco, supra* note 2, at 185 (discussing Eleventh Circuit's interpretation of "power to control" under controlling person liability).

60. *See Brown*, 84 F.3d at 396 n.6 (recognizing "important distinction between" Eighth Circuit and Eleventh Circuit standards).

61. *See id.* (discussing difference between *Metge* standard and Eleventh Circuit controlling person standard).

62. *See G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5th Cir. 1981); *see also Abbott v. Equity Grp., Inc.*, 2 F.3d 613, 620 n.18 (5th Cir. 1993) (recognizing *G.A. Thompson & Co.*'s rejection of culpable participation requirement).

63. 918 F.2d 496 (5th Cir. 1990).

64. *See id.* at 509 (outlining prima facie requirements for controlling person liability). The Fifth Circuit provided that the plaintiff must prove that "1) each [defendant] had actual power or influence over the controlled person and 2) each [controlling person] induced or participated in the alleged violation." *Id.* (citing *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981)). After the plaintiff establishes a prima facie case, the defendants can still avoid liability by establishing that "their supervision was adequate and that they did not know . . . nor could they have reasonably known" of the controlled persons' securities violation. *Id.*

65. *See Abbott*, 2 F.3d at 620 n.18 (explaining how *Dennis* erred in applying culpable participation requirement).

66. *See id.* (describing lack of need to resolve inconsistency).

67. *See Greco, supra* note 2, at 182 (describing confusion within Fifth Circuit).

participation test.⁶⁸ In *Maier v. Durango Metals, Inc.*, the court affirmed that prima facie controlling person liability requires the plaintiff to establish a federal securities violation and the controlling person's control over the primary violator.⁶⁹ Conversely to circuits applying the minority culpable participation test, the burden will then shift to the defendant, requiring him to show lack of culpable participation or knowledge of the securities violation.⁷⁰ When analyzing the requisite amount of control a controlling person must possess, the Tenth Circuit has referred to the Eighth Circuit for guidance, requiring some "indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable."⁷¹

The First Circuit has also expansively noted the controversy surrounding the culpable participation requirement.⁷² In *Aldridge v. A.T. Cross Corp.*, the defendants urged the court to adopt the stricter three-pronged controlling person liability standard applied by the Second Circuit.⁷³ The court did not define a concrete section 20(a) controlling person liability standard; however, it did rest on the control element, requiring that the "alleged controlling person must not only have the general power to control the company, but must also actually exercise control over the company."⁷⁴ Nonetheless, despite *Aldridge's* decision to not establish a complete section 20(a) controlling person liability standard, the Maine district court in *Neely v. Bar Harbor Bankshares*⁷⁵ stated that upon the plaintiff's showing of the necessary requirements, the burden shifts to the defendant to establish his or her affirmative defense of good faith, which suggests the jurisdiction could be leaning toward applying the potential

68. See *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 897 (10th Cir. 1992) (rejecting required showing of actual or culpable participation in primary violation), *rev'd*, *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); see also *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1109 (10th Cir. 2003) (noting prior rejection within Tenth Circuit); *Maier v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998) (recognizing prior rejection of culpable participation standard).

69. See *Maier*, 144 F.3d at 1305 (outlining Tenth Circuit standard for controlling person liability under section 20(a) and section 15); see also *Pring*, 969 F.2d at 897 (providing Tenth Circuit potential influence analysis).

70. See *Maier*, 144 F.3d at 1305 (describing burden shifting to defendant); see also *S.F.-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962, 964 (10th Cir. 1985) (describing defendant's burden to show lack of knowledge).

71. *Richardson v. MacArthur*, 451 F.2d 35, 41-42 (10th Cir. 1971) (employing guidance from Eighth Circuit); cf. *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967) (addressing concept of control for purposes of section 20(a) application).

72. See, e.g., *In re Stone & Webster, Inc., Sec. Litig.*, 424 F.3d 24, 26 n.2 (1st Cir. 2005) (choosing not to decide if plaintiff must establish culpable participation); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 n.6 (1st Cir. 2002) (detailing controversy surrounding culpable participation requirement); *In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33, 39 (Bankr. D. Mass. 2002) (stating First Circuit has recognized but not decided culpable participation issue).

73. See *Aldridge*, 284 F.3d at 85 (providing defendants' argument to apply Second Circuit's culpable participation controlling person standard).

74. *Id.* (describing section 20(a) control element while intentionally declining to address entire standard).

75. 270 F. Supp. 2d 50, 53 (D. Me. 2003) (stating no First Circuit cases require showing of culpability beyond active participation).

influence test.⁷⁶

2. Culpable Participation Standard

Due to the lack of clarity surrounding the controlling person provisions, a second, less widely used test has emerged, known as culpable participation.⁷⁷ First established by the Second Circuit in *Lanza v. Drexel & Co.*,⁷⁸ the culpable participation test requires a plaintiff to prove three elements in a 1934 Act section 20(a) claim.⁷⁹ First, there must be a primary violation of the 1934 Act.⁸⁰ Second, the defendant must exhibit control over the primary violator,⁸¹ and third, the controlling person must have been a culpable participant in the primary violation.⁸²

Section 20(a) of the 1934 Act also states that a controlling person may be held liable “unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.”⁸³ Courts applying the potential influence test construe this language as providing an affirmative defense.⁸⁴ In contrast, the circuits applying the culpable participation test base doing so on Congress’s intent when drafting the controlling person liability sections of the 1933 and 1934 Acts.⁸⁵ As a result, the “unless” language of section 20(a) of the 1934 Act requires plaintiffs to

76. See *id.* (providing shift of burden to defendant to show good faith). The court noted that in *Aldridge* the standard for proving control is met if the defendant was an “active participant in the decision-making process.” *Id.* at 54; see *Aldridge*, 284 F.3d at 85 (requiring showing of active decision-making abilities); *Massey*, *supra* note 40, at 119.

77. See *Massey*, *supra* note 40, at 114-15 (describing culpable participation test); see also *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998) (providing plaintiff’s burden to show defendant’s controlling person status); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (explaining culpable participation test).

78. 479 F.2d 1277 (2d Cir. 1973).

79. See *id.* at 1299; see also *Massey*, *supra* note 40, at 114-15 (describing culpable participation test).

80. See *Boguslavsky*, 159 F.3d at 720 (providing plaintiff’s burden to show defendant’s controlling person status); see also *Massey*, *supra* note 40, at 114-15 (describing culpable participation elements).

81. See *Boguslavsky*, 159 F.3d at 720 (requiring plaintiff to show defendant’s controlling person status).

82. See *Lanza*, 479 F.2d at 1299 (requiring controlling persons culpably participate in securities violation); see also *First Jersey Sec., Inc.*, 101 F.3d at 1472 (describing plaintiff’s burden of proof).

83. 15 U.S.C. § 78t(a) (2006 & Supp. V 2011).

84. See *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (stating good faith and lack of participation available as affirmative defenses); see also *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981) (describing affirmative defense of lack of participation and good faith). The Eighth Circuit in *Metge* rejected the reasoning provided by other courts with regards to the “unless” language provided in section 20(a) of the 1934 Act. See *Metge*, 762 F.2d at 631 (addressing other circuits’ decisions). But see *Rochez Bros. v. Rhoades*, 527 F.2d 880, 889-90 (3d Cir. 1975) (requiring controlling person exhibit culpable behavior); *Gordon v. Burr*, 506 F.2d 1080, 1085-86 (2d Cir. 1974) (searching for knowledge of fraudulent misrepresentations and participation). The court provided the basis for its reasoning, stating that “good faith and lack of participation are affirmative defenses in a controlling person action, and requiring them as part of the plaintiff’s prima facie case while allowing them as affirmative defenses, confuses the parties’ responsibilities and unnecessarily burdens plaintiffs . . .” *Metge*, 762 F.2d at 631.

85. See *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (interpreting congressional intent warrants culpable participation); see also *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979).

prove a mental state similar to what is necessary in a section 10(b) or SEC Rule 10b-5 cause of action.⁸⁶

The Third Circuit is the strongest proponent of the culpable participation test.⁸⁷ In *Rochez Bros. v. Rhoades*—a cornerstone case for culpable participation—the Third Circuit held that a controlling person liability claim could not be sustained under section 20(a) unless the plaintiff could establish that the defendant culpably participated in the primary securities violation.⁸⁸ This stance was reaffirmed in *Sharp v. Coopers & Lybrand*.⁸⁹ In *Sharp*, Circuit Judge Aldisert held that in order to impose secondary liability on a defendant for his inaction, the plaintiff must establish that the inaction was deliberate, intentional, and in furtherance of the fraud, as opposed to the mere presence of negligence.⁹⁰

Unlike the Third Circuit, the Second Circuit has not strictly adhered to the culpable participation test.⁹¹ Initially, the Second Circuit was firmly rooted in its application of the culpable participation test as evidenced in *Lanza* and *Gordon v. Burr*.⁹² With respect to broker-dealers, the Second Circuit failed to mention the culpable participation element established by previous rulings in *Marbury Management, Inc. v. Kohn*.⁹³ Nevertheless, this departure from the culpable participation test was short lived as *Lanza* was reaffirmed in *SEC v. First Jersey Securities, Inc.* and later in *Boguslavsky v. Kaplan*.⁹⁴

86. See *Rochez Bros.*, 527 F.2d at 885 (comparing Rule 10b-5 and section 20(a) requirements); see also Massey, *supra* note 40, at 115 (describing courts' reasoning for requiring culpable participation similar to section 10(b) and Rule 10b-5).

87. See Lowenfels & Bromberg, *supra* note 22, at 21-22 (describing Third Circuit's strict adherence to culpable participation standard); see also *SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 841 n.8 (3d Cir. 2006) (recognizing culpable participation requirement); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 284 n.16 (3d Cir. 2006) (describing prior holdings requiring culpable participation to establish liability under section 20(a)); *Rochez Bros.*, 527 F.2d at 885 (stating Congress's intent for culpable participation).

88. See *Rochez Bros.*, 527 F.2d at 890 (requiring culpable participation as element of controlling person liability).

89. 649 F.2d 175, 185 (3d Cir. 1981) (holding culpable participation element necessary to impose liability under section 20(a)).

90. See *id.*

91. Compare *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (reaffirming Second Circuit's application of culpable participation test), and *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (establishing Second Circuit's adherence to culpable participation test), with *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980) (shifting burden of proving good faith to defendant).

92. 506 F.2d 1080, 1085 (2d Cir. 1974) (affirming Second Circuit's reasoning in *Lanza*); see also Lowenfels & Bromberg, *supra* note 22, at 24 (describing confusion within Second Circuit's application of culpable participation test).

93. *Marbury Mgmt., Inc.*, 629 F.2d at 716 (shifting burden of good faith to defendant). In *Marbury Management*, the Second Circuit briefly departed from the required showing of culpable participation, holding that "the burden of proving good faith is shifted to the brokerage house and requires it to show at least that it has not been negligent in supervision." *Id.* (internal citations omitted).

94. See *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998) (reaffirming *SEC v. First Jersey Securities, Inc.*); *First Jersey Sec., Inc.*, 101 F.3d at 1472 (reaffirming use of culpable participation test); see also *Kalin v. Xanboo, Inc.*, 526 F. Supp. 2d 392, 406 (S.D.N.Y. 2007) (requiring specific culpable participation pleading with specificity within complaint). But see *Laperriere v. Vesta Ins. Grp., Inc.*, 526 F.3d 715, 724

Similar to the Second Circuit, the Fourth Circuit applied the culpable participation test in a confusing manner.⁹⁵ In *Carpenter v. Harris, Upham & Co.*, the Fourth Circuit cited *Lanza's* interpretation of Congress's intent of requiring a showing of culpable participation; however, as the vast majority of courts would argue, the test can also be interpreted as not requiring the defendant to be a culpable participant.⁹⁶ Nonetheless, in *In re Mutual Funds Investment Litigation*,⁹⁷ the court provided clarity, backing away from the culpable participation test and shifting the burden from the plaintiff to the defendant to show his or her lack of culpable participation in the underlying securities violation.⁹⁸

C. Dodd-Frank's Influence on Controlling Person Liability

In response to what has been described as "the worst financial crisis since the Great Depression," President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act in July of 2010.⁹⁹ Prior to the implementation of Dodd-Frank, the circuit courts were divided on whether the SEC had authority to bring a section 20(a) claim under the 1934 Act.¹⁰⁰ This

(11th Cir. 2008) (acknowledging courts applying culpable participation fail to require knowing participation); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 307-09 (S.D.N.Y. 2005) (noting pleading culpable participation under section 20(a) unnecessary); *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 415 (S.D.N.Y. 2003) (realizing no requirement plaintiffs plead culpable state of mind to establish culpable participation); A.A. Sommer, Jr., Commissioner, SEC, Directors and the Federal Securities Laws (Feb. 21, 1974), available at <http://www.sec.gov/news/speech/1974/022174sommer.pdf> (agreeing with *Lanza's* dissent and criticizing required showing of willful conduct).

95. *Compare* *Maier v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998) (describing shift of burden to defendant to show lack of culpable participation), *with* *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979) (relying on congressional intent in applying strict culpable participation standard).

96. *See* *Carpenter*, 594 F.2d at 394 (providing *Lanza's* interpretation of congressional intent for culpable participation element); Lowenfels & Bromberg, *supra* note 22, at 25 (describing confusion surrounding Fourth Circuit's opinion in *Carpenter*).

97. 566 F.3d 111 (4th Cir. 2009), *rev'd sub nom.* *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). *See generally* Andrew Power, Note, *The Thirteenth Stroke: An Approach to "Ultimate Authority" After Janus*, 45 SUFFOLK U. L. REV. 1297 (2012).

98. *See In re Mut. Funds Inv. Litig.*, 566 F.3d at 129-30 (describing test applied in Tenth Circuit's *Maier* case). The Fourth Circuit departed from the culpable participation test, placing the burden on the defendant to show a lack of culpable participation, similar to the majority approach, the potential influence standard. *Id.*

99. *See* Angela Maddaloni & José-Luis Peydró, *Bank Risk-Taking, Securitization, Supervision and Low Interest Rates: Evidence from the Euro Area and the U.S. Lending Standards* 7 (European Cent. Bank, Working Paper No. 1248, 2010), available at <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1248.pdf>; *see also* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 953-54 (2011) (describing implementation of Dodd-Frank).

100. *See* *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 4714250, at *5 (N.D. Cal. Oct. 7, 2011) (providing Dodd-Frank analysis, clarifying SEC's authority to bring section 20(a) enforcement actions). Congress amended the 1934 Act's section 3(a)(9) in 1975 to define the term "person" as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C. § 78c(a)(9) (2006 & Supp. V 2011); *see also* *Daifotis*, 2011 WL 4717250, at *5 (quoting definition of "person"). Courts have applied the meaning of "person" with varying results. *Compare* *SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 842 (3d Cir. 2006) (labeling SEC as "person" under 1934 Act and granting authority to bring section

division resulted from different interpretations of section 20(a)'s joint and several liability requirement, which vaguely states that a controlling person is liable "to any person to whom such controlled person is liable."¹⁰¹ In *SEC v. Coffey*, the Sixth Circuit reasoned that when establishing section 20(a) of the 1934 Act, Congress intended to solely provide controlling person liability to private persons, therefore disallowing the SEC from utilizing section 20(a) controlling person liability in injunctive enforcement actions.¹⁰² Other courts, such as the Second and Third Circuits, have expressly authorized the SEC's power to maintain enforcement actions for controlling person liability under section 20(a) of the 1934 Act.¹⁰³ Section 929P(c) of Dodd-Frank serves to clarify this distinction.¹⁰⁴ This provision effectively amends section 20(a) of the 1934 Act, affirming the SEC's authority to maintain enforcement actions under the theory of controlling person liability.¹⁰⁵

While securities litigation concerning controlling person liability has been sparse since the passage of Dodd-Frank, the Second Circuit noted the confusion regarding its requirement for culpable participation in *In re Lehman Bros. Mortgage-Backed Securities Litigation*.¹⁰⁶ Nonetheless, due to the plaintiff's failure to adequately plead the element of control, the court decided not to address the matter in the present case.¹⁰⁷ *In re Lehman Bros.* evidences the current state of disarray, and for the time being, the SEC will be obligated to prove controlling person liability depending on the jurisdiction.¹⁰⁸

20(a) claim), and *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (upholding SEC's authority to pursue enforcement action under section 20(a)), with *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (holding SEC may not rely upon 1934 Act section 20(a) in injunctive enforcement actions), and *SEC v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011, at *4 (D. Or. Sept. 3, 2003) (providing section 20(a) never intended for SEC enforcement actions).

101. § 78t(a) (establishing controlling person liability); see also *Coffey*, 493 F.2d at 1318 (providing statutory analysis of SEC's status as "person" under section 20(a)).

102. See *Coffey*, 493 F.2d at 1318 (providing statutory interpretation of SEC's authority to rely upon section 20(a)). But see *Daifotis*, 2011 WL 4714250, at *5 (analyzing discrepancies surrounding SEC's power to pursue enforcement actions under section 20(a)).

103. See *First Jersey Sec., Inc.*, 101 F.3d at 1472 (upholding SEC's authority to pursue enforcement action under section 20(a)); see also *J.W. Barclay & Co.*, 442 F.3d at 842 (labeling SEC as "person" under 1934 Act and granting authority to bring section 20(a) claim).

104. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1865 (2010) (affirming SEC's power to bring actions in federal court regarding controlling person liability); see also Hiler & Rose, *supra* note 1, at 3-4 (describing section 929P(c)'s effect on SEC's power to bring actions under controlling person liability theory).

105. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(c) (providing amendment to section 20(a) of 1934 Act). Section 929P(c) states: "Section 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78t(a)) is amended by inserting after 'controlled person is liable' the following: '(including to the Commission in any action brought under paragraph (1) or (3) of section 21(d)).'" *Id.*

106. 650 F.3d 167, 186 (2d Cir. 2011) (recognizing divided application of culpable participation element).

107. See *id.* (deciding not to address whether culpable participation required for section 15 liability).

108. See *id.* (noting controversy surrounding culpable participation requirement); see also Amanda Bronstad, *SEC Trots Out a New Weapon: Control Person Liability*, LAW.COM (Aug. 20, 2009), <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202433157801> (describing different standards that SEC

III. ANALYSIS

A. Pertinent Issues Surrounding the Culpable Participation and Potential Influence Standards

The divide amongst the circuit courts regarding controlling person liability is unacceptable, and in many cases, unnecessary.¹⁰⁹ Courts applying the minority culpable participation standard have expressly noted that it is pointless for plaintiffs to state culpable participation in order to successfully plead a section 20(a) claim.¹¹⁰ Regardless of this observation, numerous courts remain firm in believing that culpable participation must be pled with specificity within the plaintiff's complaint.¹¹¹ The differing views among courts, compounded with the implementation of Dodd-Frank, have made it all the more apparent why a single controlling person liability standard must be implemented.¹¹²

Considering that controlling person liability under sections 15 of the 1933 Act and 20(a) of the 1934 Act remains one of the primary means of providing secondary liability in private rights of securities actions, requiring plaintiffs to plead culpable participation is unduly burdensome.¹¹³ The defendant often has sole possession of evidence regarding culpable participation because plaintiffs have limited access to corporate information prior to discovery.¹¹⁴ As a result, in jurisdictions requiring the pleading of culpable participation, it can be extremely difficult, if not impossible, for plaintiffs to succeed in summary judgment motions.¹¹⁵ Therefore, one can only assume that this deficiency has played a major factor in many jurisdictions' decision to depart from culpable participation.¹¹⁶

must establish depending on jurisdiction).

109. See *Laperriere v. Vesta Ins. Grp., Inc.*, 526 F.3d 715, 724 (11th Cir. 2008) (providing courts applying culpable participation often do not require showing participation); see also *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 415 (S.D.N.Y. 2003) (stating no requirement that plaintiffs plead culpable state of mind to establish culpable participation).

110. See *supra* note 109 (describing Southern District of New York and Eleventh Circuit's observations regarding pleading culpable participation).

111. See *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (requiring culpable participation); see also *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981) (requiring plaintiff to plead culpable participation); *Kalin v. Xanboo, Inc.*, 526 F. Supp. 2d 392, 406 (S.D.N.Y. 2007) (reaffirming need for culpable participation within Second Circuit).

112. See *SEC v. Zandford*, 535 U.S. 813, 813 (2002) (advocating flexible interpretation of securities laws); see also *Massey, supra* note 40, at 123 (describing plaintiff's extremely burdensome pleading requirements of culpable participation).

113. See *supra* note 26 (describing *Central Bank of Denver's* elimination of aiding and abetting liability in private actions); see also *Massey, supra* note 40, at 123 (describing overly burdensome pleadings of culpable participation).

114. See *Massey, supra* note 40, at 123 (addressing difficulties faced by plaintiffs regarding pleading culpable participation).

115. See *Greco, supra* note 2, at 187 (discussing inadequacies of culpable participation standard).

116. See *supra* Part II.B.1 (discussing potential influence standard and courts' departure from culpable participation).

By recognizing the “unless” language provided in controlling person liability sections of the 1933 and 1934 Acts as an affirmative defense, the majority potential influence standard places the burden on the defendant, requiring a showing that he did not induce the primary violation, or that he acted in good faith.¹¹⁷ Typically, defendants can establish the affirmative defense, otherwise known as the good faith affirmative defense, by proving that reasonable procedures were taken to prevent the primary violation.¹¹⁸ This aspect of the potential control standard seems to be more in line with Congress’s intent for the controlling person provisions.¹¹⁹ In fact, this distinction between the culpable participation and potential influence standards was the driving force behind the Ninth Circuit’s decision to abandon its application of culpable participation.¹²⁰

Despite being substantially more accommodating for plaintiffs, the potential influence standard can often lead to inconsistent rulings.¹²¹ This issue stems from Congress’s conscious decision to leave the term “control” undefined, allowing courts to determine the extent of corporate directors’ and officers’ control on the merits of the cases before them.¹²² The provision of this flexible, fact-specific standard has also been criticized for potentially exposing innocent supervisory personnel to joint and several liability for the securities violations of their subordinates.¹²³ Regardless, the potential influence test offers plaintiffs a superior alternative in comparison to culpable participation’s extreme and unwarranted pleading standard.¹²⁴

117. See 15 U.S.C. § 77o (2006 & Supp. V 2011) (providing controlling person liability pursuant to section 15 of 1933 Act); *id.* § 78t (providing controlling person liability under section 20(a) of 1934 Act); see also *supra* notes 46-47 and accompanying text (providing circuit courts’ reasoning for vacating culpable participation).

118. See Lowenfels & Bromberg, *supra* note 22, at 27 (defining “good faith” defense).

119. See *supra* notes 37-39 and accompanying text (explaining statutory language of controlling person liability statutes).

120. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990) (analyzing statutory language and placing burden on defendant). Joining several other courts, the Ninth Circuit reasoned that “[a]ccording to the statutory language, once the plaintiff establishes that the defendant is a ‘controlling person,’ then the defendant bears the burden of proof to show his good faith.” *Id.*

121. See Massey, *supra* note 40, at 124 (discussing difficulty of inconsistent rulings produced by potential influence standards); Greco, *supra* note 2, at 190 (discussing inconsistent rulings as disadvantage of potential control).

122. See *supra* note 31 and accompanying text (analyzing Congress’s decision to leave control undefined); see also Massey, *supra* note 40, at 124 (discussing inconsistent rulings produced by potential influence standard); Greco, *supra* note 2, at 190-91 (criticizing potential control standard).

123. See Greco, *supra* note 2, at 190 (discussing potential control standard’s primary criticism); see also *Metge v. Baehler*, 762 F.2d 621, 630 (8th Cir. 1985) (discussing lack of congressional guidance in construing controlling person liability). Congress believed a strict definition of control would not be desirable because “[i]t would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted.” H.R. Rep. No. 73-1383, at 26 (1934).

124. See Greco, *supra* note 2, at 187 (discussing inadequacies of culpable participation standard); see also Massey, *supra* note 40, at 123 (addressing difficulties faced by plaintiffs regarding pleading culpable participation).

B. Dodd-Frank's Effect on Prior and Future Decisions

With respect of the SEC's authority to bring enforcement actions under section 20(a) of the 1934 Act, Dodd-Frank has not created new enforcement powers, but has simply clarified a power that has existed since the 1934 Act's inception.¹²⁵ The courts refusing to recognize this authority interpreted section 20(a)'s statutory language too narrowly.¹²⁶ When drafting the 1933 and 1934 Acts, "Congress recognized that efficient [and effective] regulation of securities trading could not be accomplished under a rigid statutory program."¹²⁷ Therefore, the Commission was created with flexible enforcement powers.¹²⁸ Dodd-Frank's affirmation of the SEC's authority to bring enforcement actions under the theory of the 1934 Act section 20(a) controlling person liability extends its ability to flexibly deter and combat securities fraud.¹²⁹

With section 929P(c) of Dodd-Frank affirming the SEC's power to utilize controlling person liability, the SEC will surely look to hold influential members of corporations secondarily liable for securities violations more frequently.¹³⁰ SEC Commissioner A. A. Sommer, Jr. openly expressed his disapproval of culpable participation and disagreed with the Second Circuit's contention in *Lanza* that a controlling person must act with intentional

125. See *supra* note 100 and accompanying text (describing split views on SEC's authority to bring enforcement actions under section 20(a)). Before passage of Dodd-Frank, the vast majority of courts believed the SEC was considered a "person" under the 1934 Act, and therefore possessed the power to bring enforcement actions under section 20(a). See *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 4714250, at *5 (N.D. Cal. Oct. 7, 2011) (outlining varying views regarding SEC's authority to bring section 20(a) controlling person enforcement actions). Nonetheless, until the implementation of Dodd-Frank, some courts believed that the SEC did not qualify as a "person" under section 20(a). See *SEC v. Stringer*, No. Civ. 02-1341-ST, 2003 WL 23538011, at *6 (D. Or. Sept. 3, 2003). In *Stringer*, the District Court of Oregon believed the SEC could not constitute a person under section 20(a) because the SEC is not a "person to whom such controlled person is [joint and severally] liable." *Id.*

126. See *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (stating section 20(a) only provides private persons course of action against secondary violators); see also *Stringer*, 2003 WL 23538011, at *6 (interpreting statutory text). Although Dodd-Frank is in direct opposition of the view taken by the *Stringer* court, the court does make a unique point. See *Stringer*, 2003 WL 23538011, at *6. While prior courts have focused on whether the SEC constitutes a person, the *Stringer* court phrases the issue differently. See *supra* note 100 and accompanying text (providing numerous decisions analyzing whether SEC constitutes a "person" under section 20(a)). Instead of analyzing whether the SEC complies with the statutory definition of the word "person," the court believed the true "issue is whether the SEC constitutes a 'person to whom such controlled person is liable.'" See *Stringer*, 2003 WL 23538011, at *6 (analyzing issue slightly differently than prior case law). The court reasoned that the SEC, being a government agency, is not an injured party, and although a controlling person can be held liable to a private plaintiff, he cannot be held liable to the SEC. See *id.*

127. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (describing statutory history of 1933 and 1934 Acts).

128. See *id.* (describing Congress's intent in creating SEC).

129. See *id.* (describing Congress's provision of flexible enforcement powers to SEC); see also *SEC v. Zandford*, 535 U.S. 813, 813 (2002) (explaining courts should construe 1934 Act flexibly).

130. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(c), 124 Stat. 1376, 1865 (2010) (affirming SEC's power to bring enforcement actions under controlling person liability theory).

participation.¹³¹ Courts applying culpable participation—for example the Third Circuit—require plaintiffs to show that the controlling person intentionally participated in the primary violation.¹³² In order to establish intentional participation, the plaintiff must show that the controlling person acted with the intent to facilitate the primary securities violation.¹³³

The SEC's definition of control alludes to a standard that would not require culpable participation.¹³⁴ Pursuant to the definition provided by the SEC, a corporate officer would have controlled an underlying securities violation if he or she exhibited 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."¹³⁵ This expansive definition of control is counterintuitive to the argument in favor of applying the culpable participation standard that requires a degree of intentional participation, as it provides for direct or indirect power to direct the mere management and policies of securities violators.¹³⁶ Therefore, judging from the SEC Commissioner's express criticism of intentional participation and the SEC's broad definition of control, it appears as if the SEC would prefer to apply the less-restrictive potential influence standard as opposed to culpable participation.¹³⁷

Although the affirmative defense of controlling person liability is shrouded in much confusion, the Supreme Court has not yet directly addressed the issue.¹³⁸ Nevertheless, the Court stated in *SEC v. Zandford*: "[T]he statute

131. See Sommer, *supra* note 94 (discussing *Lanza's* holding); see also Staudt, *supra* note 7, at 940 n.51 (stating in SEC's view that intentional participation not required to hold controlling persons liable).

132. See Staudt, *supra* note 7, at 942 n.60 (describing required showing of intentional participation to succeed in proving culpable participation).

133. See *Rochez Bros. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975) (providing intentional participation analysis). In defining intentional participation, the Third Circuit in *Rochez Bros.* stated that liability may be established if the controlling person was directly or indirectly involved in the primary violation. See *id.* Intentional participation, and therefore culpable participation, can be established on inaction only if it was intentional and in furtherance of the primary violation, or in an attempt to prevent authorities from discovering it. See *id.* Therefore, under the culpable participation standard, controlling persons can be held jointly and severally liable without having intentionally committed a securities violation. See *Laperriere v. Vesta Ins. Grp., Inc.*, 526 F.3d 715, 725 (11th Cir. 2008) (recognizing courts agree controlling persons do not need to commit intentional violations). In support of this proposition the Fifth Circuit stated: "[W]hat would be the purpose of the controlling person provision if intent were required the provision would hardly make anyone liable who would not be so otherwise." *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 960 (5th Cir. 1981); see also Staudt, *supra* note 7, at 943 (providing intentional participation definition).

134. See 17 C.F.R. § 230.405 (2012) (defining control).

135. *Id.*

136. See *id.* The establishment of control through a showing of direct or indirect power to direct or cause the direction of the management and policies of the controlled person through merely possessing ownership of voting securities implies that intentional conduct by the controlling person is not required. *Cf. id.*

137. See *supra* note 94 (describing SEC's historical criticism of culpable participation's requirement of intentional participation).

138. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1581 (9th Cir. 1990) (discussing Supreme Court's failure to address affirmative defense issue surrounding controlling person liability).

should be construed not technically and restrictively, but flexibly to effectuate [securities legislation's] remedial purposes.”¹³⁹ Circuits that interpret controlling person legislation as requiring culpable participation seem to have disregarded the intended flexible nature of the securities laws as enumerated by Congress and the Supreme Court.¹⁴⁰

IV. CONCLUSION

For the better part of the previous century, controlling person liability conformity has eluded the judicial system. The existence of culpable participation—especially within the Second Circuit, the epicenter of American finance and capitalism—greatly diminishes a plaintiff’s ability to merely plead controlling person liability. The recent implementation of Dodd-Frank and the SEC’s affirmed power to bring controlling person enforcement actions, destines the issue of controlling person liability for Supreme Court review. Whether the Supreme Court decides to utilize the potential control test or construct a new test to effectuate the purposes of holding controlling persons liable, the selected standard will surely be less restrictive than culpable participation, which will allow private litigants and the SEC to pursue controlling person actions with greater ease.

Michael A. Bednarz

139. SEC v. Zandford, 535 U.S. 813, 819 (2002) (describing how to construe securities legislation).

140. See *id.* (recommending flexible effectuation of securities laws).