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Rule 10b-5-The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)-Imposing a Benefit Requirement on Apparent Authority

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NOTES

Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority

I. INTRODUCTION

Over thirty-five years ago a court[1] first recognized a private cause of action for damages under section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5.[3] Since then the courts have used tort and criminal law principles to create causes of action under rule 10b-5 and have expanded its scope of liability.[4] Although nearly every court of appeals[5] has addressed the question whether the agency principle of respondeat superior is a proper basis for liability under rule 10b-5, not all of them have recognized a cause of action under the doctrine.[6]

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1. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

2. 15 U.S.C. § 78j(b) (1976). Section 10(b) provides in relevant part: "It shall be unlawful for any person, directly or indirectly, . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance . . . ."

3. 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5 forbids a person

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

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

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

4. The courts have used tort and criminal law principles to impose secondary liability under the securities acts. Courts impose this liability on defendants because of defendants' relationship with the primary wrongdoer, not because of any direct violation of a securities provision. The most widely used forms of secondary liability under the acts are aiding and abetting, conspiracy, and respondeat superior. *See* Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

5. Only the First and Eighth Circuits have not addressed this question. *See infra* authorities cited notes 15-17.

Some courts believe the Eighth Circuit's decision in Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), decided the respondeat superior question, *see, e.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 714 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Rochez Bros. v. Rhoades, 527 F.2d 880, 885 (3d Cir. 1975) ("In Myzel v. Fields, the Eighth Circuit indicated that liability for securities act violations was governed by section 20(a) and not by any agency theories.") (citations omitted). In *Myzel*, however, the Eighth Circuit actually did not consider the applicability of agency principles since it held defendant liable nnder § 20(a) of the Securities Act of 1934. *See* 386 F.2d at 738.

6. The Third and Ninth Circuits have not adopted the respondeat superior cause of action. *See infra* notes 16-17 and accompanying text; *infra* part II(A)2-3.

Respondeat superior is the common-law principle that under certain circumstances holds an employer responsible for the tortious acts of his employees and agents by attributing to him their conduct,[7] even though he himself may lack any fault. The most common use of respondeat superior is to hold an employer liable for torts that his employees committed within the scope of their employment.[8] Respondeat superior also finds employer liability for acts that are within the apparent authority of the employee and upon which third parties have relied.[9] Courts impose liability on the basis of apparent authority even if the employee has acted outside the scope of employment.[10]

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7. Seavey, *Speculations as to "Respondeat Superior,"* HARVARD LEGAL ESSAYS 433 (1934). Respondeat superior attributes the employee's wrongful act to the employer, but it does not attribute the employee's knowledge. Section 272 of the RESTATEMENT (SECOND) OF AGENCY (1958), however, provides the basis for imputing the employee's knowledge to the employer and thus is distinguishable from respondeat superior. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, at 13 n.17, Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981).

8. RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958). See *id.* § 228 for a definition of scope of employment.

9. Seavey describes respondeat superior as follows:

> *Respondeat superior,* as the phrase is commonly used, summarizes the doctrine that a master or other principal is responsible, under certain conditions, for the conduct of a servant or other agent although he did not intend or direct it. In practice, it is used chiefly with reference to the liability of a master for the torts of a servant, but its principle includes, as well, the liability of one who is not a master for the undirected contracts made for him by his agent in cases in which there is not the obvious contract basis, such as exists where the agent has apparent authority. Similar reasons lie back of the rules established for both types of situation.

Seavey, *supra* note 7, at 433.

At least one commentator distinguishes respondeat superior liability from the liability imposed on employers or principals for the misrepresentations that an employee or agent makes and upon which third parties rely. Ferson, *Bases for Master's Liability and for Principal's Liability to Third Persons,* 4 VAND. L. REV. 260, 264 (1951) ("[T]he two doctrines grew up separately and . . . they pertain to different situations. The doctrine of *respondeat superior* pertains to torts; the doctrine that a principal is bound by the authorized act of his agent pertains to contracts."). RESTATEMENT (SECOND) OF AGENCY § 257 (1958) contains this principle. *See also* Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior,* 69 CALIF. L. REV. 1513, 1513-14 n.7, 1517 n.27, 1536-37 n.111 (1981).

Clearly, the courts and other commentators recognize that the apparent authority doctrine is part of respondeat superior. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 884 (3d Cir. 1975); 10 FLETCHER, CYCLOPEDIA CORPORATIONS § 4886 (rev. ed. 1978). The justification for apparent authority liability in the contractual context is equally strong in the case of tortious misrepresentations and, therefore, the two are indistinguishable. As one court has stated, "The underlying reason is that a corporation can speak and act only through its agents and so must be accountable for any acts committed by one of its agents within his actual or apparent scope of authority and while transacting corporate business." Rochez Bros. v. Rhoades, 527 F.2d at 884.

10. An employee's action is not within the scope of employment if he did not act, at least in part, with an intent to benefit the employer. *See* RESTATEMENT (SECOND) OF AGENCY

Some courts[11] refuse to accept the respondeat superior cause of action in rule 10b-5 cases because section 20(a) of the Securities Exchange Act of 1934,[12] through its "controlling persons"[13] provision, is sufficiently broad to impose secondary liability on the basis of employment relationships. This section, however, contains a special defense which provides that a controlling person is not liable if he acted in good faith and did not induce the violation. Thus, the scope of liability under section 20(a) presumably is narrower than under respondeat superior.[14]

The majority of courts[15] hold that section 20(a) does not pre-

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§ 228(1)(c) (1958). Under apparent authority analysis, an employee who acts with the sole intent of furthering his personal interest still may subject his employer to liability if a third party (1) reasonably believes that the employee is acting within his actual authority and (2) relies upon the employee to his detriment. *See infra* part III(A)2. *See also* RESTATEMENT (SECOND) OF AGENCY § 262 (1958).

11. *See infra* authorities cited note 16.

12. Section 20(a) provides:

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

Securities Exchange Act of 1934 § 20(a), 15 U.S.C. 78t(a) (1976) (emphasis added).

13. Courts have interpreted broadly the term "control" in § 20(a). Under this approach, an employer controls his employee within the meaning of § 20(a) and is subject to liability as a controlling person. *See* Comment, *supra* note 9, at 1515 n.18 (1981). The 1934 Act defines a "person" as follows: "The term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Securities Exchange Act of 1934 § 3(a)(9), 15 U.S.C. § 78c(9) (1976).

14. Respondeat superior does not contain a good faith defense because it imposes liability on an employer regardless of fault—thus, the employer's intent is irrelevant. The courts and several commentators contend that the availability of the good faith defense under § 20(a) reduces the employer's scope of liability for employees' securities violations. Therefore, the employer's opportunity to disprove liability by relying upon the good faith defense depends upon the court's determination of whether respondeat superior applies; if it does not apply, the employer may use the good faith defense. *See, e.g.*, Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Note, *Vicarious Liability of Controlling Persons Under the Securities Acts*, 11 LOY. L.A.L. REV. 151 (1977); Comment, *supra* note 9; Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 CAL. W.L. REV. 152 (1979).

15. The courts of appeals for the Second, Fourth, Fifth, Sixth, Seventh, and Tenth Circuits have adopted the majority approach. *See, e.g.*, Commodity Futures Trading Comm'n v. Premex, Inc., 655 F.2d 779 (7th Cir. 1981); Henricksen v. Henricksen, 640 F.2d 880 (7th Cir. 1980), *cert. denied*, 102 S. Ct. 669 (1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); Fey v. Walston

empt the use of respondeat superior in securities cases because, in enacting the section, Congress did not intend to limit the remedies available to investors. A minority of jurisdictions[16] refuse to recognize respondeat superior on the ground that to do so would nullify the good faith defense of section 20(a) and thereby impose liability upon employers or principals who do not possess the requisite culpability or bad faith that Congress envisioned. Finally, the Third Circuit[17] follows a general rule that section 20(a) preempts the use of agency principles, but it recognizes an exception for broker-dealers and accounting firms, who owe the investing public a higher standard of care in supervising their employees.[18]

This Note demonstrates that the scope of employer liability for employees' rule 10b-5 violations is no broader under a proper application of respondeat superior than under section 20(a). This Note does not address the question whether respondeat superior applies under rule 10b-5, but rather how courts should apply it.

& Co., 493 F.2d 1036 (7th Cir. 1974); Kerbs v. Fall River Indus., 502 F.2d 731 (10th Cir. 1974); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970); Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730 (W.D. Va. 1982); American Gen'l Ins. Co. v. Equitable Gen'l Corp., 493 F. Supp. 721 (E.D. Va. 1980); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203 (D. Mass. 1978). *But see* National Bank of Detroit v. Whitehead & Kales Co., 528 F. Supp. 940 (E.D. Mich. 1981); Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303 (E.D. Va. 1981); *infra* part II(A).

16. The Ninth Circuit follows the minority approach. *See, e.g.*, Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968). Although the Fifth Circuit in Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980), noted that the *Kamen* court did not address directly the issue of the applicability of agency principles; the *Zweig* and *Christoffel* courts cited *Kamen* as authority for their minority view decisions. The Ninth Circuit now recognizes as "established law" that § 20(a) supplants use of respondeat superior under the securities acts. *See* Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978); Kersh v. General Council of the Assemblies of God, 535 F. Supp. 494 (N.D. Cal. 1982); *infra* part II(B).

17. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981); Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975); Walsh v. Butcher & Sherrerd, 452 F. Supp. 80 (E.D. Pa. 1978); *infra* part II(C).

18. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981) (respondeat superior applied to impose liability on an accounting firm). The Third Circuit has not yet held a broker-dealer liable under respondeat superior but has stated that it will do so when the occasion arises. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Walsh v. Butcher & Sherrerd, 452 F. Supp. 80 (E.D. Pa. 1978) (held broker-dealer exception of *Rochez Brothers* applies to respondeat superior); *see also* Plunkett v. Dominick & Dominick, 414 F. Supp. 885 (D. Conn. 1976) (noted broker-dealer exception available).

Part II examines the majority, minority, and Third Circuit decisions on employer liability. Part III discusses the traditional analysis under both respondeat superior and section 20(a) and compares the scope of liability under each one. Part III concludes that except for an employer's liability for acts that are within an employee's apparent authority yet outside the scope of employment, the results are identical in all cases under either respondeat superior or section 20(a). Thus, courts place too much emphasis on the good faith defense of section 20(a). Part IV analyzes the effect of the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*[19] on the respondeat superior cause of action. Because *Hochfelder* firmly establishes scienter[20] as a requirement in a rule 10b-5 cause of action, courts now must use respondeat superior to impute to the employer not only the employee's conduct but also his intent. In criminal cases respondeat superior often serves to impute both an employee's conduct and intent to a corporation or partnership for crimes that require specific intent. Part V of this Note examines the limitations of respondeat superior in imputing conduct and intent to an entity in criminal case law, the Model Penal Code, and proposed federal criminal code provisions. Ultimately, this Note concludes that in view of the scienter requirement, those restrictions should apply to rule 10b-5 actions to limit employer liability to those cases in which an employee acts within the scope of employment with the intent to benefit the employer. Under this approach the distinction vanishes between the scope of secondary liability under respondeat superior and under section 20(a).

II. RESPONDEAT SUPERIOR AND SECTION 20(a)—THE CONFLICT IN THE CIRCUITS

The legislative history of section 20(a) provides support for both the majority and minority positions on the applicability of respondeat superior to rule 10b-5 violations.[21] The ambiguity of

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19. 425 U.S. 185 (1976).

20. The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 194 n.12.

21. Section 20(a) does not cover expressly employment or agency relationships. The drafters of § 20(a) modeled the provision after § 15 of the Securities Act of 1933. *See* Securities Act of 1933 § 15, 15 U.S.C. § 77o (1976), *as amended by* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 208, 48 Stat. 881, 908. Section 15 sought to "preven[t] directors from evading the liabilities incident to signing the registration statement" by using "dummy" directors to sign the statements. S. REP. No. 51, 73d Cong., 1st Sess. 5 (1933). As originally enacted, § 15 imposed liability upon a person who, through stock ownership, agency, or otherwise, controls someone liable under §§ 11 or 12 of the 1933 Act. *See* Securi-

Congress' intent in enacting this section allows a court to structure its analysis of the legislative history to suit its conclusion on employer liability. Although the results in these cases, with few exceptions, are sensible, this result-oriented approach leads to strained application of respondeat superior principles.

A. The Majority Approach

Recently, the Fifth Circuit in *Paul F. Newton & Co. v. Texas Commerce Bank*[22] recognized a claim against a brokerage firm for the fraudulent conduct of its employee based upon the theory of respondeat superior. In *Newton* a registered representative of Pressman, Frohlich & Frost, Incorporated violated rule 10b-5 by participating in an elaborate scheme to inflate the price of an over-the-counter stock. The employee used his firm's name as market maker in the stock.[23] A brokerage firm that purchased some of the stock at the inflated price and eventually lost all of its investment sued Pressman under the doctrine of respondeat superior. The district court refused to apply respondeat superior and dismissed the brokerage firm's section 20(a) claim on grounds that Pressman did

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ties Act of 1933, Pub. L. No. 73-22, § 15, 48 Stat. 74, 84 (current version of 15 U.S.C. § 77). At the time of the passage of § 20(a) of the 1934 Act, Congress amended this provision to include a good faith defense. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 208, 18 Stat. 881, 908.

The minority approach focuses on the use of the term "agency" in § 15. These courts argue that since the drafters specifically included agency relationships within the scope of § 15 and since the House Report on § 20(a) also names agency as an example of control, *see* H.R. REP. No. 1383, 73d Cong., 1st Sess. 26 (1934), Congress must have intended to supplant use of common-law agency principles by enacting § 20(a). *See* Comment, *supra* note 14, at 173-74 (1977). Further, proponents of the minority viewpoint argue that the inclusion of a good faith defense in § 20(a) indicates Congress' rejection of the imposition of liability without fault upon the employer. *See* Fischel, *supra* note 4, at 98-99.

The majority approach argues that the inclusion of the word "agency" in the original version of § 15 and the mention of the term in the House Report on § 20(a) are insufficient to support a finding that Congress intended to preempt use of agency principles by enacting § 20(a). Moreover, since the purpose of § 20(a) is to prohibit use of dummies to commit securities violations, "the defenses contained in each section represent a congressional judgment that directors, officers, and major shareholders who control securities act violators should not be held strictly liable." Comment, *supra* note 9, at 1527. Because the legislative history of § 20(a) does not indicate any intent on the part of Congress to provide employers specifically with a good faith defense, nothing precludes the imposition of liability on employers through respondeat superior even though they are without fault. *Id.*

22. 630 F.2d 1111 (5th Cir. 1980).

23. *Id.* at 1113. A market maker is a middleman between the buyer and his broker and the seller and his broker. A firm announces that it is willing to act as a market maker in a particular over-the-counter stock by listing its name in the "pink sheets"—the daily publications that list over-the-counter stocks and the market makers for the stocks. Pressman's employee listed the firm's name in the pink sheets as market maker for the stock. *Id.*

not have knowledge of the employee's scheme and did not participate in the fraud.[24] The court of appeals reversed, holding that respondeat superior applies in federal securities cases.[25] The court decided that the legislative history of section 20(a) was inconclusive, and hence chose to interpret broadly the securities statutes.[26] The court reasoned that a rule limiting liability to section 20(a) in this specific factual context

> would enable the brokerage firm to escape liability under the reasoning of some circuits merely by showing that it did not "culpably participate" in the fraud committed by its employee. . . . To allow a brokerage firm to avoid secondary liability simply by showing ignorance, purposeful or negligent, of the acts of its registered representatives contravenes Congress's intent to protect the public, particularly unsophisticated investors, from fraudulent practices.[27]

The court applied respondeat superior and held Pressman liable for its employee's conduct.

B. The Minority Approach

In *Christoffel v. E.F. Hutton*[28] the Ninth Circuit espoused support for the minority view that section 20(a) preempts the use of agency principles in federal securities cases.[29] In *Christoffel* an estate brought an action against E.F. Hutton for losses sustained because of an account executive's fraud. The account executive had been guardian of the decedent while she was alive.[30] E.F. Hutton had allowed its employee to act as guardian but required expressly that he supply the firm with court approval for every transaction. The account executive diverted funds from approved sales for his own use. Besides the account executive's own illegal intentions, "no kind of fraud, misrepresentation, or unfair dealing tainted any of the sales of stocks effected through [E.F.] Hutton."[31] The court of appeals stated that "the sole basis" of plain-

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24. *Id.* at 1114.

25. *Id.* at 1118-19.

26. *Id.* at 1118 ("The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.").

27. *Id.* at 1118-19.

28. 588 F.2d 665 (9th Cir. 1978).

29. The Ninth Circuit never has analyzed fully the respondeat superior issue; rather, it has relied on the decision in Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968) as authority for its position. *See* Comment, *supra* note 9, at 1517-19 (1981); *supra* note 16.

30. The estate's deceased was an elderly woman who had been declared incompetent. Christoffel v. E.F. Hutton & Co., 588 F.2d at 666.

31. *Id.* at 667.

tiffs' respondeat superior claim against E.F. Hutton was "its employment of Schwager as an account executive during the time that he was also acting as guardian for the . . . estate."[32] The court concluded that Congress intended section 20(a) liability to be more restrictive than respondeat superior liability because section 20(a) requires that the controlling person participate in the fraud to some extent.[33] Finding that section 20(a) was the exclusive means of secondary employer liability, the court dismissed the claim because E.F. Hutton did not control the account executive in his guardianship activities within the meaning of the section.[34]

C. *The Third Circuit*

In *Rochez Brothers v. Rhoades*[35] and *Sharp v. Coopers & Lybrand*[36] the Third Circuit combined the analyses and reasoning of both the majority and minority decisions, but placed great emphasis on the nature of the defendant's business: whether the defendant was under a strong duty to supervise employees to protect the investing public. In *Rochez Brothers* the president of the corporation MS&R fraudulently purchased MS&R stock from Rochez Brothers, which sued MS&R and based its claim on respondeat superior. The district court found that the president of MS&R never had represented to Rochez Brothers that he was acting on behalf of his employer when purchasing the stock; therefore the court refused to hold MS&R liable because its president did not act within the scope of his employment.[37]

The court of appeals held that agency principles were inapplicable and dismissed the complaint.[38] The court reasoned:

> If we were to apply *respondeat superior* . . . we would in essence impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they are dealing with their own corporate stock as individuals, and not for the corporation or for the benefit of the corporation. To impose such a duty would make the corporation primarily liable for any security law violation by any officer of the corporation. We believe Congress did not intend to expand liability to this degree when it passed the Securities Exchange Act.[39]

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32. *Id.*
33. *Id.* at 668.
34. *Id.* at 669. The Ninth Circuit reasoned that only a court had the legal power to control the account executive while he acted as guardian of the estate. *Id.* at 668.
35. 527 F.2d 880 (3d Cir. 1975).
36. 649 F.2d 175 (3d Cir. 1981).
37. Rochez Bros. v. Rhoades, 390 F. Supp. 470 (W.D. Pa. 1974).
38. Rochez Bros. v. Rhoades, 527 F.2d at 880, 884-86.
39. *Id.* at 885.

The *Rochez Brothers* court noted, however, that respondeat superior may be appropriate in certain cases, such as claims against broker-dealers, because of a need for a high standard of care in supervising employees of firms that may influence greatly the investing public.[40]

The Third Circuit in *Sharp v. Coopers & Lybrand*[41] applied the *Rochez Brothers* broker-dealer exception to an accounting firm. In *Sharp* Coopers & Lybrand issued two tax opinion letters on a limited partnership tax shelter written by one of its tax supervisors. The second letter contained misrepresentations concerning the amount of deductions that the limited partnership investment would generate; several potential investors received the letter.[42] The supervising partner at Coopers & Lybrand did not review and approve the letter before it left the office. The court distinguished this factual situation from the one presented in *Rochez Brothers* by emphasizing the duty of Coopers & Lybrand to protect the public:

> In this situation, the absence of actual knowledge of or a reckless disregard for material omissions or misrepresentations should not insulate Coopers & Lybrand from liability because the expectation that investment decisions would be made on the basis of the opinion letter required the firm to exercise a "stringent duty to supervise" its employees in drafting and issuing the letter. Under the circumstances of this case viz, the existence of actual knowledge that the firm's letter would influence the investing public, we cannot distinguish the responsibility of the accounting firm here from the broker-dealer discussed in [*Rochez Brothers*].[43]

The court applied respondeat superior and held Coopers & Lybrand liable under rule 10b-5.[44]

D. Synthesis of the Majority, Minority, and Third Circuit Approaches

In framing the issues for review, the courts in both *Rochez Brothers* and *Christoffel* used language that contrasts with the lan-

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40. The court stated: "We are not faced with the type of relationship that prevails in the broker-dealer cases where a stringent duty . . . . is imposed to protect the investing public and make brokers aware of their special responsibility they owe to their customers." *Id.* at 886.

41. 649 F.2d 175 (3d Cir. 1981).

42. *Id.* at 178-79.

43. *Id.* at 184. The court also noted, "A simple garden variety master-servant relationship is not what activates the doctrine of respondeat superior in this case. Rather, the presence of what we described in [Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975)] as a 'stringent' or high duty to supervise employees triggers the doctrine." *Id.*

44. *Id.* at 184-85.

guage of the *Sharp* and *Newton* courts. In *Rochez Brothers* the court focused on the unreasonableness of holding a corporation vicariously liable for the fraudulent acts of its employee while he was dealing with his own corporate stock.[45] In *Christoffel* the court determined that the "sole basis" of Christoffel's claim was E.F. Hutton's employment of the account executive while he acted as guardian of the estate.[46] Each court concluded that Congress enacted section 20(a) to ensure that courts would extend secondary liability under the securities acts only to those controlling persons who are involved culpably in securities fraud. The courts thereby shielded both MS&R and E.F. Hutton from respondeat superior liability.

In *Sharp* the Third Circuit sounded a different tone. Focusing on Coopers & Lybrand's breach of its duty to supervise, the court refrained from taking a restrictive view of the legislative history of section 20(a)[47] and "insulating" the firm from liability. Similarly, the *Newton* court refused to follow the preemptive approach and allow Pressman, Frohlich & Frost, Incorporated to "escape liability."[48] Interpreting section 20(a) broadly on the ground that Congress did not intend to limit investors' remedies, these courts increased the scope of employer liability and provided a remedy to the plaintiffs.

The result in each of the four cases is sensible. The courts' application of agency principles, however, technically is incorrect even though employer liability intuitively is appropriate. For example, the *Sharp* court's emphasis upon a defendant's duty to supervise is inconsistent with respondeat superior analysis. Respondeat superior requires attribution of the conduct of an employee to the employer;[49] it differs from other recognized forms of secondary liability, such as aiding and abetting and conspiracy, because it applies without regard to the employer's fault.[50] Liability based on

45. Rochez Bros. v. Rhoades, 527 F.2d at 885-86.

46. Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978).

47. Sharp v. Coopers & Lybrand, 649 F.2d 175, 184 (3d Cir. 1981).

48. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980).

49. *See supra* note 8.

50. The aiding and abetting action under rule 10b-5 derives from tort law. A defendant is liable under this theory

> [f]or harm resulting to a third person from the tortious conduct of another . . . if he . . . (b) knows that the other's conduct constitutes a breach of a duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

failure to supervise, however, requires some fault on the part of the employer. Breach of this duty is *per se* a form of primary liability and does not trigger necessarily the direct attribution of conduct to the employer under respondeat superior.[51]

Implicit in each of these decisions is the misconception that respondeat superior imposes strict liability on employers for their employees' every act. For example, the court in *Rochez Brothers* stated that the use of respondeat superior would result in a holding that MS&R was liable.[52] Traditional requirements of respondeat superior—scope of employment and apparent authority—limit liability under this theory, for the facts must meet these criteria before a court will find employer liability.[53] In the next part this Note outlines the respondeat superior framework, compares it with the analysis under section 20(a), and demonstrates that in most cases the results are the same under either approach.

III. The Scope of Liability Under Respondeat Superior and Section 20(a)

Traditionally, courts have advanced several justifications for holding an employer responsible for his employees' acts under respondeat superior:[54] The employer controlled the acts of his employee; the employer decided to hire and entrust the employee with various duties in return for the anticipated profit from performance of his job; the employment provided the employee with the opportunity to commit the wrong; and the employer should

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Restatement of Torts § 876 (1939). Conspriracy liability also requires the defendant's knowledge and participation in the fraud. *See* Fischel, *supra* note 4, at 83-85.

51. Breach of the duty to supervise constitutes primary liability when the duty delegated by the employer is a nondelegable one. *See infra* note 201 and accompanying text.

52. "If we were to apply *respondeat superior* . . . we would in essence impose a duty . . . [that] would make the corporation primarily liable for any security law violation by any officer or employee of the corporation." Rochez Bros. v. Rhoades, 527 F.2d at 885.

53. *See* Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1119 (5th Cir. 1980). The court stated that

> [t]o utilize common-law agency principles to determine secondary liability for violations of the securities acts does not expose corporations, employers, and other such potential defendants to strict liability for all acts of their agents or cause them to become insurers of their agent's actions. The familiar requirements of agency that the agent act within the course and scope of his employment and that he act within his actual or apparent authority serve to restrict the scope of the principal's liability.

Id.

54. *See* W. Prosser, Handbook of the Law of Torts 459 (4th ed. 1971); Douglas, *Vicarious Liability and the Administration of Risk II*, 38 Yale L.J. 720, 722 (1929); Ferson, *supra* note 9, at 263, 270-74; Seavey, *supra* note 7, at 447; Brief of the Securities and Exchange Commission, *supra* note 7, at 15 n.21.

have an incentive to conduct his business safely. Another more modern justification for respondeat superior is the "deep pocket" theory—that is, the employer should bear the risk of loss as part of the cost of doing business because he can better absorb the financial loss caused by the employee than can an innocent third party.[55] Under this rationale, the goal of applying respondeat superior is to provide compensation: the employer should pay for the damages caused by an employee, regardless of his culpability. Conversely, the traditional approaches emphasize some affirmative conduct on the part of the employer. As this part of the Note explains, the determination of whether the purpose of respondeat superior is fault-based or compensatory affects greatly the scope of respondeat superior liability under rule 10b-5.

A. Respondeat Superior

1. Scope of Employment

The definition of scope of employment is flexible, as one commentator pointed out by describing it as "so devoid of meaning itself that its very ingeniousness has been of value in permitting a desirable degree of flexibility in decisions."[56] The Restatement (Second) of Agency enumerates several factors that courts examine to determine whether an employee acted within the scope of his employment: "(1) Conduct of a servant is within the scope of employment if, but only if: (a) it is of the kind he is employed to perform; (b) it occurs substantially within the authorized time and space limits; (c) it is actuated, at least in part, by a purpose to serve the master . . . ."[57] Tortious conduct is within the scope of employment if the employee's acts satisfy these requirements.[58]

One of the most difficult determinations in securities cases is whether the employee's conduct is of the type his employer hired him to perform. Obviously, if an employer has authorized the specific conduct, it is within the scope of employment.[59] When the employer has not authorized the activity, however, courts examine

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55. W. PROSSER, *supra* note 54, at 459; Douglas, *supra* note 54, at 722; Seavey, *supra* note 7.

56. W. PROSSER, *supra* note 54, at 460.

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

58. *Id.* § 231 provides that "[a]n act may be within the scope of employment although consciously criminal or tortious."

59. *See id.* § 229, comment a (1958). "As stated in Section 212, a master is responsible for an act or result which he intends the servant to perform or acbieve if the servant acts because of his directions." *Id.*

several factors to determine whether it resembles sufficiently the authorized conduct to fall within the scope of employment. These criteria include the following: Whether the act is one that is done commonly by employees; the nature of the previous relations between the employer and employee; whether the act is outside the scope of the employer's business; whether the employer has reason to expect that this type of conduct will occur; and the extent of departure from the normal method of accomplishing an authorized result.[60]

Lewis v. Walston & Co.[61] illustrates the use of these factors in making the scope of employment determination in the securities context.[62] In *Lewis* plaintiffs Lewis and MacDonald sued Walston & Co., a brokerage firm, and its registered representative, DeCasenave, for damages due to losses from the purchase of unregistered securities of Allied Automation (Allied). For an extended period, DeCasenave strongly recommended the Allied stock to plaintiffs, who were longtime Walston customers.[63] Gaff, the Walston manager who supervised DeCasenave, knew that she was promoting the stock and advised her to limit her recommendations to less risky investments. Gaff, however, never discussed the Allied stock with plaintiffs and never ordered DeCasenave to stop her efforts.[64] Plaintiffs purchased some Allied stock and subsequently suffered losses. The court found DeCasenave guilty of violating section 12(2) of the Securities Act of 1933 and held the brokerage firm liable for her conduct based on the theory of respondeat superior.[65] The court reasoned that DeCasenave acted within the scope of her employment.[66]

Walston argued unsuccessfully that DeCasenave acted outside

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60. *Id.* § 229(2)(a), (c)-(f), & (i) (1958).

61. 487 F.2d 617 (5th Cir. 1973).

62. Although *Lewis* arose out of a claim under § 12(1)-(2) of the Securities Act of 1933, 15 U.S.C. § 771(1) (1976), and not under rule 10h-5, the court's analysis is useful as an illustration of the scope of employment determination.

63. Lewis v. Walston & Co., 487 F.2d at 619. DeCasenave told the investors that this machine company was a "potential IBM." She described the company, discussed its plans for product development, showed plaintiffs the company's literature, emphasized its growth potential, and urged them to get in on the "ground floor" of this investment. *Id.*

64. *Id.* at 620.

65. *Id.* at 624.

66. *Id.* at 623. The court found that recommending the Allied stock, informing customers of developments in the company they were considering as an investment, and arranging the mechanics of the purchase and sale were " 'acts commonly done' by brokers . . .; at the very least, they . . . [are] 'similar in quality' to acts brokers are routinely authorized to perform." *Id.*

the scope of employment by selling the Allied stock because Walston did not deal in unregistered securities; DeCasenave departed from her routine by failing to place the order through the New York office; Gaff advised DeCasenave against dealing in the stock; and Walston did not receive any commission on sales of Allied stock.[67] Citing the Restatement (Second) of Agency, the court reasoned that even if Walston did not authorize the sale of unregistered stock, the transaction was, nevertheless, within the scope of employment because it was "sufficiently similar" to authorized conduct.[68] The court rejected Walston's argument that the transaction occurred in an unusual manner, stating that "[b]rokers may and do take many actions in the course of their dealings with customers that do not relate directly to transactions executed through the brokerage house . . . ."[69] The court viewed Gaff's advice to DeCasenave as a personal recommendation, not as one made in his official capacity as a Walston manager.[70] Finally, because "the scope of employment does not require that the act have conferred any particular benefit, financial or otherwise, in the employer," the court described as "not of controlling importance" Walston's argument that it gained no financial benefit from DeCasenave's sales.[71]

In its analysis of the benefit requirement in the scope of employment determination, the *Lewis* court recognized that the important consideration is whether the employee intended to benefit the employer, not whether the employer actually received a benefit. Section 235 of the Restatement (Second) of Agency defines the benefit requirement as follows: "An act of a servant is not within the scope of employment if it is done with no intention to perform it as a part of or incident to a service on account of which he is employed."[72] The comments to this section explain that when an employer authorized or directed his employee's conduct, an inference arises that the servant intended to benefit the employer and thus, that he acted within the scope of his employment.[73] Even if a dual purpose of serving both the employer and himself motivated the employee's conduct, his actions may be within the scope of

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67. *Id.* at 623-24.

68. *Id.* at 624. *See* RESTATEMENT (SECOND) OF AGENCY § 229(2) (1958). *See supra* text accompanying note 60.

69. Lewis v. Walston & Co., 487 F.2d 617, 624 (5th Cir. 1973).

70. *Id.*

71. *Id.*

72. RESTATEMENT (SECOND) OF AGENCY § 235 (1958).

73. *Id.* Comment a. *See* Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976).

employment.[74]

Notwithstanding that the proper focus is upon the employee's state of mind, many courts place importance—particularly in scope of employment cases concerning brokerage firms—upon whether the employer received any actual benefit. In particular, if the employer received a commission from the employee's act, courts conclude frequently that a desire to serve the master motivated the employee's conduct in part.[75]

2. Apparent Authority

In *Holloway v. Howerdd*[76] plaintiffs claimed that TSI, a brokerage firm, was liable under respondeat superior for the acts of its registered representative, Tucker. Tucker had violated section 12(2) of the 1933 Act[77] by selling over $100,000 worth of unregistered stock in Modular Properties, Inc. (Modular) to more than 140 people. At trial Tucker testified that he had advised many investors that he was allowing them to buy the stock as a personal favor and that he was not acting as a representative of TSI in the transaction. Tucker had used only his personal stationery when he wrote to any of the investors and did not charge them any commission. He testified, however, that he failed to inform some investors that he was not representing TSI in the transaction.[78]

TSI contended that it did not know or have reason to know that Tucker participated in the illegal stock sales. The firm pointed to the close system of supervision its manager maintained over its registered representatives. Further, TSI argued that it was not liable because it did not deal in shares of Modular and did not receive any commission on Tucker's sales.[79]

Determining that agency principles applied under the securities acts, the Sixth Circuit found TSI liable only to those buyers who were aware of Tucker's status with TSI and dealt with him in

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74. RESTATEMENT (SECOND) OF AGENCY § 236 (1958). *See id.* § 235 comment b.

75. *See, e.g.*, Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1975); Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

76. 536 F.2d 690 (6th Cir. 1976). The district court opinion is set forth at 377 F. Supp. 754 (M.D. Tenn. 1973).

77. 15 U.S.C. § 771(2) (1976). The *Holloway* decision provides an example of the use of the apparent authority doctrine under the securities acts. No court has decided a 10b-5 respondeat superior case on the ground of apparent authority. *See* Comment, *supra* note 9, at 1513-14 n.7.

78. Holloway v. Howerdd, 536 F.2d at 693-94.

79. *Id.* at 695.

that capacity.[80] It refused to extend TSI's liablity to those persons who purchased the stock from Tucker with clear knowledge that he was acting in his individual capacity and not as a TSI representative.[81] Thus, the court did not base its decision upon a finding that Tucker acted within the scope of his employment, but that he acted as an agent "within his apparent or ostensible authority."[82] Further, the court justified its liability decision on the ground that even though TSI usually did not deal in unregistered securities, it was under an affirmative duty to prevent the use of the firm's reputation to defraud the investing public.[83]

Although the Sixth Circuit did not discuss the apparent authority analysis in great detail, the result in this case indicates clearly that the court imposed liability without regard to the employee's intent.[84] This lack of a requirement that the employee acted to benefit the employer distinguishes respondeat superior liability for acts within apparent authority from respondeat superior liability for conduct within the scope of employment. In *Holloway* Tucker acted with the sole intent of benefiting himself. Thus, his sale of Modular stock was not within the scope of his employment. Under apparent authority analysis, however, the court could extend TSI's respondeat superior liability to those investors who relied on Tucker's relationship with TSI, even though Tucker acted outside the scope of his employment. Although apparent authority liability is broader than scope of employment liability, the courts rarely have relied upon it to find vicarious liability in securities

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80. *Id.* at 696. ("The general law of agency recognizes that a principal is bound by the acts of an agent done within his apparent or ostensible authority.").

81. The court stated:

> "A general agent for a disclosed or partially disclosed principal subjects his principal to liability for acts done on his account which usually accompany or are incidental to authorized conduct if, although they are forbidden by the principal, the other party reasonably believes that the agent is authorized to do them and has no notice that he is not so authorized."

Id. at 696 (quoting RESTATEMENT (SECOND) OF AGENCY § 161 (1957)).

82. 536 F.2d at 696.

83. *Id.* ("When its agents are dealing individually in the sale of securities TSI must be clearly disassociated from those transactions, as otherwise it will incur liability on the basis of respondeat superior for the fraudulent misrepresentations of its agents.").

84. An employer is held liable under the apparent authority doctrine for an employee's fraudulent acts upon which third parties rely. Courts may impose apparent authority liability even if an employee is acting outside the scope of employment and solely to further his personal interests. Courts consider primarily whether a third party reasonably believed that the employee was acting within his scope of employment—the employee's intent, therefore, is irrelevant. *Id.*

cases.[85]

B. Section 20(a)

Section 20(a) states that "[e]very person who, directly or indirectly, controls any person" who commits a securities violation is 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 violation."[86] The defendant's control of the primary wrongdoer is the threshold issue under section 20(a). The legislative history of section 20(a) suggests that Congress was not contemplating employment relationships when it enacted the provision.[87] The term "control," however, is broad enough to include these types of relationships.[88] Accordingly, courts have held brokerage and accounting firms liable as controlling persons of their employees within the meaning of this section.[89] A mere showing that an employment relationship exists, however, does not establish automatically section 20(a) control. For example, in *Christoffel*[90] the court held that E.F. Hutton did not control its account executive while he acted as guardian of the estate, even though he was an E.F. Hutton employee.[91] In the context of the employment relationship, "control" clearly refers to control of the employee in the circumstances under which the violation occurred.

The majority of courts,[92] several commentators,[93] and the Se-

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85. *See supra* note 77.

86. See *supra* note 12 for the full text of § 20(a).

87. *See supra* note 21; *see also* Comment, *supra* note 9, at 1515 n.18.

88. Comment, *supra* note 9, at 1515 n.18.

89. *See, e.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175, 185 (3d Cir. 1981) (accounting firm controls tax supervisor employee); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980) (brokerage firm found in dicta to have controlled trainees—case decided on respondeat superior grounds).

90. Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978); *see supra* notes 28-34 & 45-52 and accompanying texts.

91. Christoffel v. E.F. Hutton & Co., 588 F.2d at 667-68. Similarly, the *Rochez Brothers* court held that MS&R did not control Rhoades within the meaning of § 20(a). *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 889-91 (3d Cir. 1975).

> It is our belief that *Rhoades* was the "controlling person," not MS&R. Rhoades was Chairman of the Board, chief executive officer and President of MS&R and owned fifty per cent of the issued and outstanding stock. Rhoades ran the day-to-day business activities of MS&R and obviously had the power to influence the policies and actions of MS&R. Rochez's argument that MS&R is a "controlling person" must therefore fail because Rhoades and MS&R cannot simultaneously be "controlling persons" as to each other.

Id. at 891. (emphasis in original). *See supra* notes 35-40 & 45-52 and accompanying texts.

92. *See, e.g.*, Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (3d Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S.

curities and Exchange Commission[94] interpret section 20(a) to provide that once the plaintiff establishes control, the burden of proof shifts to the defendant controlling person to demonstrate the good faith and noninducement elements of the section's special defense. The defendant satisfies the good faith element if he shows that he "maintained and enforced a reasonable and proper system of supervision . . . over controlled persons so as to prevent, so far as possible, violations of Section 10(b) and Rule 10b-5."[95] Courts have not addressed specifically the noninducement element of the defense.

The standard of supervision required of a firm that is not under a strict duty to protect the investing public is set forth in *Zweig v. Hearst Corp.*[96] In that case Campbell, a financial columnist with the *Los Angeles Herald Examiner,* wrote a column praising the financial condition, product line, and management of a corporation. Campbell did not reveal in the article that he recently had purchased stock in this company. The price of the stock increased sharply after publication of Campbell's column; he sold his investment for a profit, and eventually, the stock price dropped. Plaintiffs sued Campbell for causing fiuctuations in the stock price in violation of rule 10b-5 and sued Hearst Corporation as Campbell's controlling person under section 20(a).

After finding that Hearst Corporation was a controlling person within the meaning of section 20(a),[97] the court declined to hold a newspaper to the high standard of supervision required of broker-dealers. The court reasoned that "to liken the relationship between a newspaper owner publishing financial news and a reader-investor to the practically fiduciary relationship between the broker and his

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1011 (1980). For cases holding that plaintiff must show defendant's "culpable participation" in the fraud, see Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981); Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975).

93. *See, e.g.,* S. JACOBS, THE IMPACT OF RULE 10b-5 § 40.04 (1974); Ruder, *Multiple Defendants in Securities Fraud Cases,* 120 U. PA. L. REV. 597, 602 (1972).

94. Brief of the Securities and Exchange Commission, *supra* note 7, at 30-33.

95. Zweig v. Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied,* 423 U.S. 1025 (1975); *see* Fey v. Walston & Co., 493 F.2d 1036, 1051 (7th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1301 (2d Cir. 1973); Richardson v. MacArthur, 451 F.2d 35, 42 (10th Cir. 1971); Gordon v. Burr, 366 F. Supp. 156, 169 (S.D.N.Y. 1973), *modified in part on other grounds,* 506 F.2d 1080 (2d Cir. 1974); Moerman v. Zipco, Inc., 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff'd on opinion below,* 422 F.2d 871 (2d Cir. 1970), *reh'g denied,* 430 F.2d 362 (1970).

96. 521 F.2d 1129 (9th Cir.), *cert. denied,* 423 U.S. 1025 (1975).

97. 521 F.2d at 1132.

customer is to depart from reality."[98] Rather, the court decided that some lesser standard would be appropriate.[99]

The court held that Hearst Corporation had acted in good faith by supervising Campbell adequately.[100] The newspaper had employed Campbell for thirty years, during which time Hearst Corporation never had received any complaints about his columns. Campbell selected the column topic, and although the newspaper authorized the managing editor to make any changes in the substance of the text, he never had done so.[101] The newspaper was unaware of Campbell's financial interest in the corporation because it never conducted investigations into the financial affairs of its employees without cause. Several people made inquiries about the published article; thereafter, the newspaper stopped printing Campbell's pieces until it completed a full investigation.[102] The court reasoned that a newspaper must expect that its employees accurately will report facts until given reason to believe otherwise because the practicalities of publishing a large daily newspaper preclude having supervising editors check every item published.[103] The court also found that the suspension of Campbell's column after Hearst Corporation received inquiries supported a finding of good faith.[104]

Hecht v. Harris, Upham & Co.[105] illustrates the proof of good faith required of employers that are under a strong duty to protect investors. The *Hecht* court found Wilder, a registered representative of Harris, Upham & Company, guilty of churning[106] in an elderly widow's account. The court held Harris, Upham & Company liable as a controlling person under section 20(a) for Wilder's fraudulent conduct.[107] The court reasoned that the brokerage

98. *Id.* at 1135.

99. *Id. See* G.A. Thompson & Co. v. Partridge, 636 F.2d 945 (5th Cir. 1981); Carpenter v. Harris, Upham & Co., 594 F.2d 388 (4th Cir.), *cert. denied*, 488 U.S. 868 (1979); SEC v. Savoy Indus., 587 F.2d 1149 (D.C. Cir. 1978); Quinto v. Legal Times of Wash., Inc., 506 F. Supp. 554 (D.D.C. 1981).

100. Zweig v. Hearst Corp., 521 F.2d at 1135-36.

101. *Id.* at 1135.

102. *Id.* at 1133.

103. *Id.* at 1135.

104. *Id.* at 1136.

105. 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

106. Churning occurs when a broker purchases and sells securities in amounts that are excessive given the nature of his client's account. Generally, churning constitutes a fraud under § 10(b) of the 1933 Act. *Id.* at 431-32.

107. *Id.* at 438-39.

firm's failure to maintain an adequate system of supervision over Wilder precluded it from escaping liability under the good faith defense.[108]

The court noted that standard practice[109] in the brokerage industry requires that a partner in a firm learn the essential facts about each customer, usually by interviewing the customer before opening the account. Moreover, a partner must continue to supervise diligently the registered representative's handling of that account. The internal procedures[110] of Harris, Upham & Company required partners to approve any speculative trading in a woman's account. The evidence disclosed that the partner in charge of Wilder never met the customer and for several years knew very little about the account even though it was one of the firm's most actively—and often speculatively—traded[111] and lucrative accounts.[112] After examining the evidence, the court concluded that "[t]he most effective means for insuring adequate supervision is to impose liability for injury resulting from its absence."[113] Furthermore, the court found that the failure of the brokerage firm to supervise Wilder demonstrated that it did "indirectly induce, participate in, approve and accept the benefits"[114] of its employee's churning. Therefore, the firm failed to meet the requirements of the good faith defense of section 20(a).

Taking a minority position, the Third Circuit requires plaintiffs who seek to establish a section 20(a) claim to demonstrate not only control but also that the controlling person culpably participated in the securities violation.[115] Critics of this requirement argue that, in effect, it imposes a burden on plaintiffs to negate the section 20(a) good faith defense.[116] If a plaintiff shows that a con-

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108. *Id. See* Bird v. Ferry, 497 F.2d 112, 117 (5th Cir. 1974) (Coleman, J., dissenting); Troyer v. Karcagi, 476 F. Supp. 1142 (S.D.N.Y. 1979).

109. The court examined the publications of the American Association of Stock Exchange Firms and the National Association of Securities Dealers to determine the standard practice of the industry. Hecht v. Harris, Upham & Co., 283 F. Supp. at 438.

110. The court used the supervisory memorandum of Harris, Upham & Company as evidence of the firm's internal procedures. *Id.*

111. The broker dealt in securities on margin and commodity futures trading for the widow's account. *Id.* at 439.

112. *Id.*

113. *Id.* (quoting Lorenz v. Watson, 258 F. Supp. 724, 733 (E.D. Pa. 1966)).

114. 283 F. Supp. at 439.

115. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 889-91 (3d Cir. 1975). The court held "that secondary liability cannot be found under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud." *Id.* at 890.

116. *See, e.g.*, Brief of the Securities and Exchange Commission, *supra* note 7, at 30-33.

trolling person was a culpable participant in the fraudulent conduct of its employee, then clearly the controlling person cannot demonstrate the good faith and noninducement elements of the defense.

C. *Comparison of the Scope of Liability Under Respondeat Superior and Section 20(a)*

Thus far this Note has discussed several cases that fall neatly into the following three categories: (1) the court applies section 20(a) and holds the employer liable; (2) the court applies section 20(a) and does not hold the employer liable; and (3) the court applies respondeat superior and holds the employer liable.[117] This section of the Note analyzes each of these categories to determine whether the court would have reached the same result had it applied respondeat superior instead of section 20(a) in the first two categories or section 20(a) instead of respondeat superior in the last category. This section concludes that the results are identical under either section 20(a) or the scope of employment branch of respondeat superior. Only the scope of liability under the apparent authority branch of respondeat superior—as the court in *Holloway v. Howerdd*[118] defines it—is greater than the scope of liability under section 20(a).

1. Employer Held Liable Under Section 20(a)—*Hecht*

In *Hecht v. Harris, Upham & Co.*[119] the court held defendant liable as a controlling person under section 20(a) for churning by its employee in an elderly widow's account. If the court had analyzed the facts under respondeat superior, it nonetheless would have held Harris, Upham & Company liable because the employee's acts were within the scope of his employment; his purchase and sale of securities, albeit fraudulently excessive, were acts authorized and necessary to his occupation as a stockbroker.

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117. A fourth category *a priori* would be: the court applies respondeat superior and holds the employer not liable. No cases, however, exist in this category.

118. 536 F.2d 690 (6th Cir. 1976); see *supra* notes 76-85 and accompanying text for a discussion of this case.

119. 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); see *supra* notes 105-14 and accompanying text for a discussion of this case.

2. Employer Not Liable Under Section 20(a)—*Christoffel, Rochez Brothers, & Hearst*

In *Christoffel v. E.F. Hutton & Co.*[120] the court held that E.F. Hutton was not a controlling person under section 20(a) while its employee acted as guardian of an estate. If the court had applied respondeat superior to the facts, E.F. Hutton likewise would not have been held liable. Because E.F. Hutton had refused to authorize any transactions unless the employee first obtained court approval, the employee was not acting within the scope of his employment while serving as guardian.[121] Furthermore, the evidence revealed that E.F. Hutton had taken several precautionary measures to ensure that its employee acted on his own behalf and that when he dealt with the estate no one relied on his status as an E.F. Hutton employee.[122] Thus, E.F. Hutton would not be liable under either a scope of employment or an apparent authority theory.

In *Rochez Brothers v. Rhoades*[123] the court held that under section 20(a) MS&R was not liable for its president's fraudulent purchase of stock. The court noted that the president and not MS&R was the controlling person because he owned fifty percent of MS&R stock.[124] The court refused to apply respondeat superior because to do so "would in essence impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they [were] dealing with their own corporate stock as individuals . . . ."[125] The court assumes in this statement that MS&R would be liable under respondeat superior; this assumption, however, clearly is incorrect. Apparently the court overlooked the scope of employment requirement of the doctrine, whose purpose is to prevent the imposition of this sort of unreasonable duty upon the employer. When purchasing the stock, the president of MS&R was not acting within the scope of his employment. The transaction was part of a buy-sell agreement between Rhoades and

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120. 588 F.2d 665 (9th Cir. 1978); see *supra* notes 28-34 and accompanying text for a discussion of this case.

121. The court's analysis in Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973), supports this conclusion, because acting as a guardian for an estate is not "commonly done" by a stockbroker in the course of his employment. *See supra* note 66 and accompanying text.

122. *See supra* text accompanying note 31.

123. 527 F.2d 880 (3d Cir. 1975); see *supra* notes 35-40 and accompanying text for a discussion of this case.

124. 527 F.2d at 883; *see supra* note 91.

125. 527 F.2d at 885.

MS&R.[126] Furthermore, trading in stock for a personal account is not commonly considered to be within the scope of employment of a director or officer.[127] Because the president never made any representation to Rochez Brothers that he was acting for MS&R in the transaction, but rather stated to Rochez Brothers that the purchase was for his own benefit,[128] an apparent authority argument likely would fail.

In *Zweig v. Hearst Corp.*[129] the Ninth Circuit held that Hearst Corporation was not liable for the stock-price fluctuations that resulted from the columnist's activities because Hearst Corporation did not induce the securities law violations or act in bad faith.[130] If the court had applied respondeat superior, the outcome regarding the liablity of Hearst Corporation would be debatable. Arguably, writing an article recommending a stock is within the scope of a financial columnist's employment. A court reasonably could conclude, however, that the columnist did not act within the scope of his employment because he did not intend to benefit the Hearst Corporation. Since his intent was to benefit himself, the court should hold that the corporation is not liable.

3. Employer Held Liable Under Respondeat Superior—*Newton, Sharp, & Lewis*

In *Paul F. Newton & Co. v. Texas Commerce Bank*[131] the court held that Pressman, Frohlich & Frost, Incorporated was liable under respondeat superior for its employee's fraudulent scheme to infiate the price of a stock. If the court had applied section 20(a), it likewise would have found Pressman liable. Pressman's registered representative used the firm's name as market maker and Pressman's failure to realize this activity is strong evidence that the firm's supervisory controls were insufficient to meet section 20(a) standards.[132] Thus, Pressman could not prove the good faith element of the section 20(a) defense.

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126. *Id.* at 884.

127. *See supra* note 66.

128. *See supra* text accompanying note 37.

129. 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); see *supra* notes 96-104 and accompanying text for a discussion of this case.

130. 521 F.2d at 1133.

131. 630 F.2d 1111 (5th Cir. 1980); see *supra* notes 22-27 and accompanying text for a discussion of this case.

132. *See* Hecht v. Harris, Upham & Co., 283 F. Supp. at 438-39; *supra* note 95 and accompanying text; *supra* text accompanying notes 108-14.

In *Sharp v. Coopers & Lybrand*[133] the court held Coopers & Lybrand liable under respondeat superior for a tax associate's fraudulent misrepresentation in a tax opinion letter. Like Pressman, Coopers & Lybrand would have been liable under section 20(a) because the partner's failure to review the opinion letter falls short of the supervision required to invoke the good faith defense of section 20(a).[134] In *Lewis v. Walston & Co.*[135] the court held Walston & Company liable under respondeat superior for its employee's purchase of unregistered securities, although the court also could have reached the same result under section 20(a). The failure of Walston & Company to order its employee not to recommend the unregistered stock indicates both a lack of good faith under section 20(a) and perhaps a direct or indirect inducement of the violation.[136]

4. The Apparent Authority Case—*Holloway v. Howerdd*

In the majority of cases that have considered whether respondeat superior is available as a remedy in rule 10b-5 actions, the resulting employer liability is identical to that found under section 20(a). Employer liability under respondeat superior is different from section 20(a) liability only in those cases that apply apparent authority. For example, in *Holloway v. Howerdd*[137] the court applied apparent authority and held that TSI was liable only to those investors whom TSI's employee did not tell that he was acting for his own benefit. Under section 20(a), however, TSI would have escaped liability even to those investors who relied on the employee's apparent authority. TSI was unaware of the sale of unregistered securities by its employee and even the most stringent system of supervision likely would have failed to uncover the fraud. Thus, if TSI could demonstrate adequate supervision of its employees, it successfully would fulfill the good faith and noninducement ele-

133. 649 F.2d 175 (3d Cir. 1981); see *supra* notes 41-44 and accompanying text for a discussion of this case.

134. As amicus curiae, the SEC claimed in this case that Coopers & Lybrand was primarily liable for the securities law violation. The Commission argued that the use of respondeat superior was unnecessary to impose liability because the accounting firm's name was on the opinion letter and, thus, it held itself out to the public as responsible for the contents. Brief of the Securities and Exchange Commission, *supra* note 7, at 2-3.

135. 487 F.2d 617 (5th Cir. 1973); see *supra* notes 61-71 and accompanying text for a discussion of this case.

136. *See supra* text accompanying notes 86-95.

137. 536 F.2d 690 (6th Cir. 1976); see *supra* notes 76-85 and accompanying text for a discussion of this case.

ments of the section 20(a) defense.

The apparent authority situation, as *Holloway* presents it, is the most difficult to resolve under respondeat superior analysis. Clearly, the court's ultimate determination of employer liability should rest upon its view of the purpose of respondeat superior; hence, the court must decide whether the doctrine is fault-based or compensatory. If the goal is to compensate the plaintiff, the employer should be liable to third parties who rely upon an employee's acts done outside the scope of employment with no intent to benefit the employer. This Note suggests, however, that courts should use apparent authority to impose liability on employers only when the employer is at fault. This Note discusses the use of apparent authority in criminal cases and advocates that courts should apply the same parameters used therein to securities cases—that is, they should restrict corporate and partnership liability to cases in which the employee acts for his employer's benefit. This benefit limitation places a reasonable boundary on corporate responsibility and is consistent with the recently established scienter requirement. The next part of this Note discusses whether the use of apparent authority in securities cases is appropriate considering the scienter requirement in rule 10b-5 actions.

IV. The Effect of the Rule 10b-5 Scienter Requirement on Respondeat Superior

In *Ernst & Ernst v. Hochfelder*[138] the Supreme Court held that scienter[139] is a necessary element of a rule 10b-5 cause of action. During an audit of a brokerage firm, Ernst & Ernst negligently had failed to discover an officer's fraud.[140] Plaintiffs, who were customers of the firm, claimed that Ernst & Ernst was liable under rule 10b-5 as an aider and abettor[141] in the fraud. The court dismissed the action and held that negligence is an insufficient basis of liability under rule 10b-5 because Congress' purpose in enacting the provision was to proscribe intentional conduct: decep-

138. 425 U.S. 185 (1976).

139. See *supra* note 20 for a definition of scienter.

140. First Securities Company of Chicago hired Ernst & Ernst to conduct audits of the firm's books and records. Lester B. Nay, president of First Securities, induced customers to invest money in nonexistent escrow accounts and then took the money for his own use. 425 U.S. at 189.

141. *Id.* at 190. Plaintiffs claimed that Ernst & Ernst's failure properly to audit First Securities made it an aider and abettor in the employee's fraud.

tion, manipulation, and fraud.[142]

The Securities and Exchange Commission argued as amicus curiae that this legislative intent to protect investors against false and deceptive practices made a negligence standard appropriate under rule 10b-5.[143] Because fraud has the same effect on investors whether it is negligent or intentional, the Commission claimed that Congress, when enacting rule 10b-5, must not have been seeking to distinguish the two types of conduct.[144] The Court rejected this argument, stating, "[The] logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support."[145]

Examining its holding from a policy perspective, the Court stated in a footnote[146] that a negligence standard would "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts."[147] The Court feared that this threatened expansion would lead to " 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class.' "[148] Furthermore, the Court warned, " 'The hazards of a business conducted on these terms are so extreme as they enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [it] to these consequences.' "[149]

The effect of the scienter requirement on secondary liability under rule 10b-5 is not clear. No court of appeals has considered the impact of *Hochfelder* on the respondeat superior cause of action. The majority approach applies respondeat superior without regard to the scienter requirement.[150] Similarly, most courts have continued to permit a cause of action for aiding and abetting under rule 10b-5.[151] Rather than hold that the scienter requirement ren-

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142. *Id.* at 193. The Court refused to address "the question of whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id.* at 194 n.12.

143. *Id.* at 212.

144. *Id.*

145. *Id.* at 198.

146. *Id.* at 214 n.33.

147. *Id.*

148. *Id.* at 215 n.33 (quoting Ultramares Corp. v. Touche, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931) (Cardozo, C.J.)).

149. *Id.*

150. *See supra* note 15.

151. *See* Fischel, *supra* note 4, at 81.

Despite the restrictive trend in the Supreme Court, lower courts, relying on various

ders this cause of action unavailable under the rule, these courts have added scienter to the elements of aiding and abetting.[152] One commentator,[153] however, argues that *Hochfelder* and several other recent decisions require strict construction of the securities acts.[154] Using this analysis, Professor Fischel contends that secondary liability,[155] other than that provided in section 20(a), no longer is appropriate.[156] Professor Fischel uses the factual setting of *Marbury Management, Inc. v. Kohn*[157] to demonstrate his view of the effect of scienter upon the respondeat superior cause of action.[158] In *Marbury* the court held that a brokerage firm may be liable under respondeat superior for the fraud that its trainee commits within the scope of his employment.[159] Professor Fischel reasons that the employer would not be primarily liable under a strict construction of rule 10b-5 because "[a] broker-dealer that does no more than employ an individual who engages in prohibited conduct . . . has not itself engaged in a manipulative or deceptive practice and certainly has not acted with scienter as required by *Hochfelder*."[160]

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common law doctrines, have continued to expansively interpret the scope of securities laws in the area of secondary liability without express statutory mandates for doing so. Every court of appeals that has faced the issue, for example, has held that a defendant can be liable for "aiding and abetting" a violation by another defendant of section 10(b) and rule 10b-5 . . . .

Id.

152. For example in IIT v. Cornfield, 619 F.2d 909 (2d Cir. 1980), the Second Circuit set forth the three requirements for aiding and abetting following *Hochfelder*: "(1) the existence of a securities law violation by the primary . . . party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in achievement of the primary violation." *Id.* at 922.

153. *See* Fischel, *supra* note 4, at 80.

154. Professor Fischel argues that the Court's decisions in Piper v. Chris-Craft Indus., 430 U.S. 1 (1977), Cort v. Ash, 422 U.S. 66 (1975), and J.I. Case Co. v. Borak, 377 U.S. 426 (1964), demonstrated the Court's shift from the use of tort law as a basis for implying remedies in securities cases. Fischel, *supra* note 4, at 90-91. Professor Fischel then argues that the Court's rejection of tort law as a basis for implying remedies under the securities acts is shown in Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979), and Touche Ross & Co. v. Redington, 442 U.S. 560 (1979). Fischel, *supra* note 4, at 91-92. He states that "the dispositive question in determining whether to imply a private remedy is whether Congress intended to create such a remedy, regardless of tort law principles." He reasons that "congressional intent must be equally dispositive in the secondary liablity context." *Id.* at 93.

155. Professor Fischel refers specifically to respondeat superior altbough he also analyzes the aiding and abetting and conspiracy causes of action. *See* Fischel, *supra* note 4, at 102-11.

156. *Id.* at 94-102.

157. 629 F.2d 705 (2d Cir. 1980).

158. Fischel, *supra* note 4, at 106-07.

159. 629 F.2d 705 (2d Cir. 1980).

160. Fischel, *supra* note 4, at 107.

Professor Fischel argues that the court should impose secondary liability only if the employer is a controlling person under section 20(a).[161] He poses the hypothetical situation in which an employee or agent engages in a fraudulent securities scheme and the board of directors knows of the scheme.[162] In this case the brokerage firm would be liable because the court could impute the knowledge of the board of directors to the firm and thus satisfy the scienter requirement.[163]

Under Professor Fischel's analysis the plaintiff must overcome a virtually insurmountable burden to obtain recovery under the securities acts. How is the plaintiff to prove that a board of directors knew of a lower-level[164] employee's fraud? Indeed, how might a board of directors, particularly one of a large corporation, ever be aware of such activity? Without the availability of respondeat superior, the class of plaintiffs that could sue under rule 10b-5 would shrink to a size far smaller than the one that the Supreme Court contemplated in *Hochfelder*.[165]

An employer may be responsible or somehow at fault for his employee's violations even though he is not aware of the wrongful acts. A corporation only can act through its employees or agents[166] and, indeed, the question of respondeat superior never arises in many cases because the court determines that the acts of the employees constitute corporate action. For example, in *Hochfelder* plaintiffs named as defendant Ernst & Ernst, and not the individual employees who conducted the negligent audit. Apparently, the employees' conduct unquestionably was that of the accounting firm and plaintiffs never raised the respondeat superior issue.[167] When the board of directors knows of the employee's action and fails to stop it, respondeat superior is not necessary because the board constructively affirms the conduct.[168] This ratification makes it proper to characterize the action as corporate. In other instances, such as *Marbury*, the employee's acts did not necessarily constitute corporate conduct.[169] The application of respondeat superior

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161. *Id.*

162. *Id.* at 107 n.145.

163. *Id.*

164. Sales and clerical personnel are examples of lower-level employees.

165. *See supra* notes 150-60 and accompanying text.

166. *See* Rochez Bros. v. Rhoades, 527 F.2d 880, 884 (3d Cir. 1975); 10 FLETCHER, *supra* note 9, § 4886.

167. *See* RESTATEMENT (SECOND) OF AGENCY §§ 82-104 (1958).

168. *See id.* § 94.

169. Logically, the likelihood that a court will characterize conduct as belonging to the

in this factual situation would connect the employee and the employer by imputing the employee's conduct and intent to the employer even though the employer was unaware of the fraudulent conduct.[170] This type of liability properly is characterizable as secondary liability—although the employer has not committed the primary violation, he still is responsible for it. Secondary liability is necessary to ensure that the class of potential plaintiffs under rule 10b-5 does not diminish to a greater extent than *Hochfelder* requires.[171]

The appropriate question after *Hochfelder* is under what circumstances may a court properly impute not only the fraud but the intent of the employee to the employer? Scienter requires some culpability of the employer before the court can justify imposing rule 10b-5 liability. Yet fictional entities such as corporations and partnerships cannot possess the mental state that scienter encompasses.

For several years courts have found corporations guilty of specific intent crimes.[172] Courts have used the principle of respondeat superior to attribute to a corporation the mens rea necessary for conviction.[173] The courts have used the principle selectively, limiting it to ensure the punishment only of culpable corporations.[174] An examination of the use of respondeat superior in the corporate criminal liability context, therefore, is important to determine the effect of the scienter requirement on rule 10b-5 respondeat superior analysis.

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employer is directly proportional to the number of employees who are participating in the fraudulent scheme. In *Hochfelder* several employees apparently worked on the allegedly negligent audit and the respondeat superior question never arose. In *Marbury*, however, only one employee acted fraudulently, and the employer sought—albeit unsuccessfully—to escape liability by arguing that the trainee did not act within the scope of employment; hence, his actions were not those of the brokerage firm.

170. *See supra* note 7. Respondeat superior attributes only the employee's conduct to the employer. To justify secondary liability after *Hochfelder*, however, courts not only must attribute the employee's conduct to the employer, but also his knowledge and intent. *See infra* part V for a discussion of the use of the respondeat superior doctrine to attribute the employee's intent and conduct to the employer.

171. *See supra* notes 146-49 and accompanying text.

172. The earliest cases that imposed criminal liability on corporations for specific intent crimes arose during the period 1875-1910. *See* Elkins, *Corporations and the Criminal Law: An Uneasy Alliance*, 65 KY. L.J. 73, 96 & n.88 (1976). *But see* Mueller, *Mens Rea and the Corporation*, 19 U. PITT. L. REV. 21, 28-32 (1957).

173. *See* Note, *Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1246-51 (1979).

174. *See infra* part V.

V. USE OF RESPONDEAT SUPERIOR TO IMPOSE CORPORATE CRIMINAL LIABILITY

A. Case Law

The early American courts adhered to the view that they could not find a corporation or partnership guilty of a crime because a fictional entity could not possess a culpable mental state.[175] The courts first surmounted this obstacle to entity criminal liability by extending the civil law principles of respondeat superior to criminal actions against corporations and partnerships for violations of regulatory statutes.[176] In *New York Central & Hudson River Railroad v. United States*[177] the Court held a corporation criminally liable for an employee's knowing violations of a railroad statute.[178] The Court found "no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them" in criminal cases.[179] In *United States v. A & P Trucking Co.*[180] the court recognized that "it is elementary that such impersonal entities [as partnerships] can be guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of *respondeat superior*."[181] Next, the courts applied respondeat superior in actions

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175. *See, e.g.*, State v. Morris & Essex R.R., 23 N.J.L. 360, 370 (1858) (corporations not "liable for any crime of which a corrupt intent of *malus animus* is an essential ingredient"); Elkins, *supra* note 172, at 95-96 n.84.

176. *See* Elkins, *supra* note 172, at 89-96. Generally, the first entities held criminally liable were quasi-corporations such as municipalities and businesses created to maintain public roads. Their crime consisted of nuisance—or nonfeasance—for the failure to fulfill their public duty. *Id.* at 93.

177. 212 U.S. 481 (1901).

178. The agent of the railroad company had made rebates to customers in violation of the Elkins Act. *Id.* at 489-91.

179. *Id.* at 494-95. The Court also noted:

> We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted authority to act . . . , and whose knowledge and purposes may well be attributed to the corporation for which the agents act. While the law should have regard to the rights of all, and to those of corporations no less than to those of individuals, it cannot shut its eyes to the fact that the great majority of business transactions in modern times are conducted through these bodies, . . . and to give them immunity from all punishment because of the old and exploded doctrine that a corporation cannot commit a crime would virtually take away the only means of effectually controlling the subject-matter and correcting the abuses aimed at.

Id. at 495-96.

180. 358 U.S. 121 (1958).

181. *Id.* at 125. The Court stated: "True, the common law made a distinction between a corporation and a partnership, deeming the latter not a separate entity for purposes of

against corporations and partnerships for common-law specific intent crimes.[182] In *Telegram Newspaper Co. v. Commonwealth*[183] the court used respondeat superior to uphold a corporation's conviction for criminal contempt, explaining, "[A] corporation may be liable criminally for certain offences, of which a specific intent may be a necessary element, [because t]here is no more difficulty in imputing to a corporation a specific intent in criminal proceedings than in civil."[184] Thus, courts now accept fully the doctrine of respondeat superior in criminal actions.

A finding of employer criminal liability under respondeat superior requires that an employee "(1) commit a crime (2) within the scope of employment (3) with the intent to benefit the corporation."[185] The federal courts will attribute the conduct of any employee to the employer under respondeat superior without regard to the employee's status in the corporate hierarchy.[186] The courts, however, have disagreed about whether to impute an employee's intent to the employer when no link exists between the employee's conduct and the corporate management. The majority of courts require no connection with or authorization by corporate executives or policy-making officials for respondeat superior to apply to the

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suit. But the power of Congress to change the common-law rule is not to be doubted." *Id.* at 124. The Court reasoned that Congress intended to change the rule in the Motor Carrier Act, which defendant had violated, because it expressly included a partnership within the statute's definition of "person." *Id.* This logic applies with equal force under the Securities Act of 1934 because a court may construe the term "person" to include partnerships for purposes of the Act. *See supra* note 13.

Courts also have held corporations criminally liable based on the aggregate knowledge of their employees even though no single employee had sufficient knowledge of the crime to constitute intent. *See, e.g.*, United States v. T.I.M.E.-D.C., Inc., 381 F. Supp. 730 (W.D. Va. 1974).

182. *See* Elkins, *supra* note 172, at 96 n.88.

183. 172 Mass. 294, 52 N.E. 445 (1899).

184. *Id.* at 297, 52 N.E. at 446.

185. Note, *supra* note 173, at 1247.

186. *See, e.g.*, United States v. Illinois Cent. R.R., 303 U.S. 239 (1938) (railway yardmaster violated statute by failing to notify appropriate personnel to unload cattle); Steere Tank Lines v. United States, 330 F.2d 719 (5th Cir. 1963) (truck driver falsified daily logs in violation of federal regulation); United States v. Carter, 311 F.2d 934 (6th Cir. 1963) (company president made illegal payments to union officials in violation of Taft-Hartley Act); St. Johnsbury Trucking Co. v. United States, 220 F.2d 393 (1st Cir. 1955) (rating clerk failed to comply with ICC regulations); United States v. Armour & Co., 168 F.2d 342 (3d Cir. 1948) (middle management employee's participation in illegal price fixing); United States v. George F. Fish, Inc., 154 F.2d 798 (2d Cir.) (salesmen compelled consumers to purchase unwanted goods as condition to purchasing rationed item), *cert. denied*, 328 U.S. 869 (1946); United States v. T.I.M.E.-D.C., Inc., 381 F. Supp. 730 (W.D. Va. 1974) (dispatcher of trucking company allowed ill driver to work in violation of ICC regulation); Elkins, *supra* note 172, at 106.

employee's actions.[187] For example, in *St. Johnsbury Trucking Co. v. United States*[188] the court held the trucking company liable for failure to comply with ICC regulations in labelling trucking shipments even though no member of the board of directors or corporate executive knew of the illegal conduct. The court explained that a corporation is answerable for the guilt of an agent or employee who acts within his scope of employment and "has the guilty knowledge, in accordance with the general principles of liability as applied in determining civil liability."[189] The court held that the corporation could not avoid criminal liability by establishing that it had acted with care and had supervised adequately the employee in an attempt to prevent the violation.[190]

A minority of courts, however, refuse to impute the intent of the subordinate employee to the corporation unless a nexus exists between the employee's conduct and the corporation's high-level executives.[191] *People v. Canadian Fur Trappers Corp.*[192] demonstrates the minority's rationale. Plaintiffs in *Canadian Fur Trappers* charged the corporation with its salesmen's larceny. The court distinguished the proof of intent required for larceny from the proof required for a violation of a regulatory statute:

> When it comes, however, to such crimes as larceny, there enters as a necessary element the intent accompanying the act. . . . The mere knowledge and intent of the agent of [sic] the servant to steal would not be sufficient in and of itself to make the corporation guilty. While a corporation may be guilty . . . of the intent to steal, the evidence must go further than in the cases involving solely the violation of prohibitive statutes. The intent must be the intent of the corporation, and not merely that of the agent.[193]

Although most courts reject the *Canadian Fur Trappers* limitation on the imputation of a subordinate employee's intent to the corporation,[194] many apply a "function" test when no link exists.[195] In *United States v. Armour & Co.*[196] the court relied upon the following standard: " 'It is the function delegated to the corporate officer or agent which determines his power to engage the corpora-

187. *See* Elkins, *supra* note 172, at 107-08 n.124; cases cited *id.*
188. 220 F.2d 393 (1st Cir. 1955).
189. *Id.* at 398 (Magruder, C.J., concurring).
190. *Id.* at 398-99 (Magruder, C.J., concurring).
191. *See* Elkins, *supra* note 172, at 108-10.
192. 248 N.Y. 159, 161 N.E. 455 (1928).
193. *Id.* at 163, 161 N.E. at 456.
194. At least one commentator agrees with the *Canadian Fur Trappers* approach. *See* Mueller, *supra* note 172, at 41-46.
195. *See* Elkins, *supra* note 172, at 106.
196. 168 F.2d 342 (3d Cir. 1948).

tion in a criminal transaction.' "[197] In *Armour* the managers and assistant managers of a large corporation violated regulations prohibiting tie-in sales[198] after the corporation had sent out interbranch correspondence and had held instructional meetings cautioning against the illegal conduct.[199] The court stated that the corporation's size, which made personal supervision by high-level officials impossible and required them to rely upon managers to exercise due care, did not relieve the corporation of its duty to eliminate tie-in sales.[200] The supervisory function that the corporate executives delegated to the assistant managers and managers gave these employees the ability to bind the corporation for their criminal acts. The court based liability upon the nonperformance of a nondelegable duty of supervision and technically not upon respondeat superior. The court reasoned that an officer must stand or fall on his selection of employees to fulfill the corporate duty to eliminate regulatory violations.[201]

The Fifth Circuit rejected the function test in *Standard Oil Co. of Texas v. United States*[202] in which the subordinate employee of an oil company participated in a scheme to sell oil in violation of the Connally Hot Oil Act.[203] The district court used the function test to find the corporation criminally liable for the employee's conduct. The court of appeals reversed, holding that the employee did not act within the scope of his employment because he intended to defraud the oil company, not to benefit it.[204] The court stated:

> It is for this reason that the simple "function" test applied by the District Court—while obviously a factor of relevance—is alone insufficient upon which to rest convictions here. Thus the taking in or paying out of money by a bank teller, while certainly one of his regular functions, would hardly cast the corporation for criminal liability if in such "handling" the faithless employee was pocketing the funds as an embezzler or handing them over to a confederate under some ruse.[205]

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197. *Id.* at 344 (quoting C.I.T. Corp. v. United States, 150 F.2d 85, 89 (9th Cir. 1945)).

198. A tie-in sale occurs when a company forces its customers to buy one product as a condition for the sale of another product. *See* 168 F.2d at 343.

199. *Id.* at 342-43.

200. *Id.* at 343-44.

201. *Id.* (quoting Cardozo, C.J., in People v. Sheffield Farms-Slawson-Decker Co., 225 N.Y. 25, 30, 121 N.E. 474, 476 (1918)).

202. 307 F.2d 120 (5th Cir. 1962).

203. Connally Hot Oil Act, ch. 18, 49 Stat. 30 (1935) (current version at 15 U.S.C. § 715-715l (1976)).

204. 307 F.2d at 128-29.

205. *Id.* at 128 (footnote omitted).

B. Model Penal Code

The Model Penal Code provision that addresses the liability of corporations or associations for crimes committed by their agents states in relevant part:

> (1) A corporation may be convicted of the commission of an offense if:
>
> (a) the offense is a violation or the offense is defined by a statute . . . in which a legislative purpose to impose liability on corporations plainly appears and the conduct is performed by an agent of the corporation acting in behalf of the corporation within the scope of his office or employment . . . ; or
> (b) the offense consists of an omission to discharge a specific duty or affirmative performance imposed on corporations by law; or
> (c) the commission of the offense was authorized, requested, commanded, performed or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment.[206]

The Code contains a due diligence defense for a corporation prosecuted under section 1(a), which allows it to avoid liability if it can prove that "the high managerial agent having supervisory responsibility over the subject matter of the offense employed due diligence to prevent its commission."[207] The Code defines a "high managerial agent" as an officer of a corporation, a partner in a partnership, or any other agent of a corporation or association "having duties of such responsibility that his conduct may fairly be assumed to represent the policy of the corporation or association."[208]

The Model Penal Code approach to corporate liability in section 1(a) is similar to the Fifth Circuit's analysis in *Standard Oil*[209] in that the Code will not impose criminal liability unless the agent acts on behalf of the corporation. The comments to this section explain that the drafters inserted the phrase "in behalf of the corporation" to ensure that a court would not hold a corporation liable for acts of its agents that are detrimental to the corporation.[210] Accordingly, although the bank teller's conduct in the hypothetical

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206. MODEL PENAL CODE § 2.07(1) (proposed official draft 1962). Section 2.07(3), which applies to unincorporated associations, is very similar to § 2.07(1)(a) and (b) except that it does not include a subpart analogous to § 2.07(1)(c), because such a provision would raise "far too many controversial questions to be feasibly included in the Code." *Id.* § 2.07 note on status of section, revision 3.

207. *Id.* § 2.07(5).

208. *Id.* § 2.07(4).

209. See *supra* notes 2-5 and accompanying text for a discussion of this case.

210. *See* Elkins, *supra* note 172, at 111.

situation set forth in *Standard Oil*[211] would suffice to impose criminal liability under the "function" test, the behavior would not result in a similar finding under this Code section.

One author suggested that if read strictly, section 1(a) is not necessarily consistent with the *Standard Oil* corporate benefit requirement.[212] " '[I]n behalf of the corporation' " may define merely the relationship between the agent and the corporation and not necessarily require that the agent intended to *benefit* the corporation.[213] Thus, under this strict construction an agent may act "in behalf of" the corporation, even though he benefits solely himself and harms the corporation.[214] Although this interpretation does not conflict with the actual language of the section, the comments clearly show that this approach is contrary to the drafters' intent.[215]

The due diligence defense for employers in criminal actions under section 1(a) emphasizes the employer's status within the corporation in determining whether corporate liability is appropriate. The defense comports with the *Canadian Fur Trappers*[216] limitation on imputing a subordinate employee's intent to the employer by recognizing that the corporation, and not merely the agent, must have intended the act.[217] The defense requires some "link" with high-level officials for corporate liability and thus is similar to the good faith defense of section 20(a). Both provisions are aimed at protecting an employer or a controlling person from liability when he has maintained an adequate supervisory system.

The focus upon supervision in the Code's due diligence defense is somewhat analogous to the Third Circuit's respondeat superior exception for firms under a high duty to protect the investing public.[218] The Third Circuit's analysis imputes liability in one step: once a court determines that a firm is under a high standard of care to supervise its employees, the court will impute to the employer the fraud committed by any employee within the scope of his employment.[219] The Model Penal Code, however, adds an inter-

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211. *See supra* text accompanying note 205.
212. *See* Elkins, *supra* note 172, at 111-12.
213. *Id.* at 112.
214. *Id.*
215. *See supra* note 210 and accompanying text.
216. See *supra* notes 192-93 and accompanying text for a discussion of this case.
217. *See supra* note 207 and accompanying text.
218. *See supra* notes 35-44 and accompanying text.
219. *Id.* A determination by the court that a defendant is under a high standard of care to supervise employees in order to protect the investing public triggers the respondeat

mediate step to its analysis. The Code first will impute a subordinate employee's illegal conduct to a high managerial supervisor; if the latter fails to show due diligence, then the second step imputes the employee's conduct and intent to the employer corporation.[220]

Section 1(b) of the Model Penal Code adopts in part the function test that some courts have applied.[221] The section, however, limits the use of the standard to situations in which the law has imposed upon the employer the duty that he delegated to the employee. Examples of these nondelegable duties include unloading cattle within statutorily prescribed time limits,[222] and the filing of daily logs by trucking companies.[223] As these examples demonstrate, the aim of the section is to impose liability only upon corporations that fail to fulfill their affirmative statutory duties.[224] Hence, in the *Standard Oil* hypothetical situation,[225] the bank as employer of the teller would not be liable under this section because the law does not impose upon the bank an affirmative duty to hand out and take in money. The presence of section 1(a) with its benefit requirement ensures that section 1(b) of the Code is not subject to interpretation as a whole-hearted adoption of the function test.

Finally, section 1(c) of the Code[226] focuses upon violations by subordinate employees that high-level managerial officials have authorized, ratified, or recklessly permitted. This provision is consistent with section 20(a) because both penalize employers who fail to supervise adequately their employees or who direct their employees to act illegally. Clearly, if a corporation approves of an employee's illegal conduct, the corporation likely intended the conduct and should be responsible for it.[227]

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superior attribution process. *See, e.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981).

220. *See supra* note 206 and accompanying text.

221. *See supra* notes 194-201 and accompanying text.

222. *See* United States v. Illinois Cent. R.R., 303 U.S. 239 (1938); Note, *supra* note 173, at 1253 n.55.

223. *See* United States v. E. Brooke Matlack, Inc., 149 F. Supp. 814 (D. Md. 1957); Note, *supra* note 173, at 1253 n.55.

224. 149 F. Supp. at 819-20.

225. *See supra* text accompanying note 205.

226. MODEL PENAL CODE § 2.07(1)(c) (proposed official draft 1962).

227. Professor Fischel's hypothetical brokerage firm, *supra* text accompanying notes 162-71, would be criminally liable for ratifying the employee's fraudulent acts under this Code provision.

C. Proposed Federal Criminal Codes

Both the Senate[228] and the House of Representatives[229] versions of the proposed federal criminal code provide that an organization, whose definition includes corporations and partnerships,[230] can be criminally liable for the acts of its agents that are within the scope of their employment or authority and are intended to benefit the organization.[231] Both versions also impose liability for acts of agents that the organization ratifies.[232] Furthermore, the proposed criminal code holds liable employers who fail to discharge specific duties imposed on the organization by law.[233] These provisions include the *Standard Oil* benefit requirement and reject the function test analysis in a manner that is consistent with the Model Penal Code approach.

The Senate and House versions differ from the corresponding Model Penal Code provision[234] because they do not contain a due diligence defense. Thus, they do not limit the imputation of a subordinate employee's intent to the employer. Moreover, they reject the minority requirement of a link between high-level executives and subordinate culpable activity set forth in *Canadian Fur Trappers*.[235] Rather, the proposed code adheres to the following three general requirements of the criminal law doctrine of respondeat superior: That an employee commit the crime with the required intent, in the scope of employment, and with an intent to benefit the organization.[236]

VI. Conclusion

The limitations that courts have placed upon respondeat superior analysis in the criminal law context demonstrate an unwillingness to hold an entity liable for the conduct of employees that is beyond its control. The *Standard Oil* benefit requirement, present in the Model Penal Code and in both versions of the proposed federal criminal code, recognizes that courts should not attribute to

228. S. 1630, 97th Cong., 1st Sess., 127 Cong. Rec. S9769-76 (1981).

229. H.R. 4711, 97th Cong., 1st Sess., 127 Cong. Rec. H7195 (daily ed. Oct. 7, 1981); H.R. 1647, 97th Cong., 1st Sess., 127 Cong. Rec. H370 (daily ed. Feb. 4, 1981).

230. H.R. 1647, *supra* note 229, § 101(29).

231. *Id.* § 502(1)(B).

232. *Id.*

233. *Id.* § 502(2).

234. *See supra* notes 206-08 and accompanying text.

235. See *supra* notes 192-93 and accompanying text for a discussion of this case.

236. *See supra* note 185.

an employer the intent of an employee who acts solely for his own benefit and outside the scope of his employment. Further, an employer cannot necessarily prevent such conduct through due care and adequate supervision. In this situation, therefore, employer criminal liability serves no purpose. By imposing a penalty only when an employee commits a crime within the scope of employment with at least some intent to benefit the employer, the deterrent value of the sanction remains effective.[237]

The reasons for limiting respondeat superior liability in the criminal law context apply equally to rule 10b-5 violations since *Hochfelder* announced the scienter requirement for rule 10b-5 liability. If courts will impute the conduct and intent of an employee to the employer in order to fulfill this requirement, then they must limit the imputation to instances in which the employer is somehow responsible for the fraudulent conduct. The benefit requirement ensures this result. If an employee intends to benefit an employer by his actions, courts reasonably may impute fraudulent intent to the employer. If an employee is not acting within the scope of employment or for his employer's benefit, the employer's participation in the fraudulent conduct does not logically follow in a manner consistent with the scienter requirement.

This benefit requirement equates the scope of liability under respondeat superior and the scope under section 20(a). Under the courts' present analysis, disparate results under respondeat superior and section 20(a) occur only when an employee acts within his apparent authority with no intent to benefit the employer.[238] The adoption of the benefit requirement, however, would preclude employer liability under both respondeat superior and section 20(a) in a factual situation such as *Holloway v. Howerdd*,[239] in which the corporation was unaware of its employee's fraudulent stock sales even though it acted with due care and adequate supervision. The *Holloway* decision, which imposed liability on apparent authority grounds, emphasized the protection of defrauded investors. Although its concern is consistent with the purposes of the securities acts,[240] to extend this protection until employer's liability is

237. If an employer is liable for any and all of tbe acts of employees, then the incentive to control and supervise employees' actions decreases.

238. *See supra* text accompanying notes 61-75, 86-96 & 137.

239. 536 F.2d 690 (6th Cir. 1976). See *supra* text accompanying notes 76-85 for a discussion of this case.

240. *See supra* text accompanying note 143.

equivalent to insurer's liability is unreasonable.[241] A court realistically could not hold that TSI intended its employee's fraudulent conduct in view of the scienter requirement of rule 10b-5. Application of the benefit limitation would prevent this imputation.

This suggested approach to respondeat superior liability does not change significantly employer liability under rule 10b-5. Because only one apparent authority case has arisen under the securities acts,[242] and none specifically under rule 10b-5, scope of employment is flexible and broad enough to cover most rule 10b-5 respondeat superior claims. The benefit requirement, which, in effect, precludes use of apparent authority as a basis for liability, simply ensures that a court will not hold an employer liable for the violations of his employees who are acting on their own behalf. Only rarely is an employee's conduct distinguishable from that of the employer. The scienter requirement, however, mandates that the courts recognize the distinction.

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241. *See supra* text accompanying notes 54-55.

242. *See supra* note 239 and accompanying text.

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