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Section 20(A) Or Respondeat Superior?: An Update

NOTES

SECTION 20(a) OR RESPONDEAT SUPERIOR?: AN UPDATE

Section 20(a) of the Securities Exchange Act of 1934 (1934 Act)[1] imposes vicarious liability for securities fraud on controlling persons for the conduct of controlled actors, unless the controlling persons acted in good faith and did not induce the controlled actors' conduct.[2] A debate over whether section 20(a) preempts common law agency theories in actions for securities fraud exists among the circuit courts.[3] The federal circuits remain split on

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1. 15 U.S.C. §§ 78a-78jj (1982). The stock market crash of 1929 and the resulting depression gave rise to passage of the Federal Securities Act of 1933 and Securities Exchange Act of 1934. H. OLECK, MODERN CORPORATION LAW § 1577 (1959). The purpose of the 1934 Act is to regulate trading in securities markets and require disclosure of information to persons involved in the purchase and sale of securities. *Id.*

2. *See* 15 U.S.C. § 78(t) (1982) (establishing vicarious liability of controlling persons for securities fraud). Section 20(a) of the Securities Exchange Act of 1934 provides that:

> (a) 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 is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78(t) (1982).

3. *See, e.g.*, Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (stating that common law agency is appropriate basis of recovery for federal securities violations); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (holding that § 20(a) does not preclude finding of liability based on apparent authority); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 777 (9th Cir. 1984) (stating that controlling person provisions in federal statutes supplant use of respondeat superior doctrine). The doctrine of respondeat superior is a common law theory of vicarious liability that holds a master liable for the torts of a servant that occur while the servant is acting within the scope of employment. RESTATEMENT (SECOND) OF AGENCY § 219 (1958). A master is a principal who employs an agent and possesses the right to control the conduct of the agent. *Id.* § 2. A servant is an agent whose conduct is subject to the principal's control. *Id.* The scope of employment required for respondeat superior liability involves a servant's conduct that is of the kind that the master has employed the servant to perform, that occurs substantially within authorized time and space limits, and that the servant actuates at least in part with a purpose to serve the master. *Id.* § 228. Once the prerequisites are met, a principal is liable for the conduct of a servant without a finding of fault on the part of the principal. W. BURBY, REFRESHER HANDBOOK ON AGENCY 60 (3d ed. 1960).

The doctrine of apparent authority holds a principal liable for the conduct of an agent when the principal holds the agent out as a person who is authorized to act for the principal and a third party relies on the representation of authority. SEAVEY, LAW OF AGENCY 13 (1964). Originally, respondeat superior applied to torts, while apparent authority applied to contracts. RESTATEMENT (SECOND) OF AGENCY § 257 (1958). Modern application, however, involves overlapping of the doctrines of respondeat superior and apparent authority. Note, *Rule 10b-5 - The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a) - Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383, 1385 (1982). Unlike

the issue.[4] Some circuits have held that section 20(a) is not the exclusive remedy for securities violations.[5] The Ninth Circuit, however, maintains that section 20(a) preempts common law agency principles.[6] The recent decisions of three federal circuits have fueled the debate surrounding the exclusivity issue.[7] Despite the variety of responses among the circuits, the United States Supreme Court has yet to consider the exclusivity of section 20(a).[8]

While the Supreme Court has not addressed the exclusivity issue, commentators offer numerous explanations to support or to refute the

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respondeat superior, however, apparent authority may hold a principal liable for the acts of an agent that are outside the scope of employment and that are effected to further the agent's self-interest. *Id* at 1399.

4. *See infra* notes 5 & 6 and accompanying text (discussing treatment of exclusivity issue among circuits).

5. *See, e.g.*, Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (adopting use of common law agency to impose vicarious liability upon principals for securities violations); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (holding that apparent authority is appropriate measure of liability for securities violations); Henricksen v. Henricksen, 640 F.2d 880, 888 (7th Cir.) (holding broker-dealer liable for securities violation under both § 20(a) and common law doctrine of respondeat superior), *cert. denied*, 454 U.S. 1097 (1981); Paul F. Newton & Co. v. Texas Commerce, 630 F.2d 1111, 1119 (5th Cir. 1980) (stating that § 20(a) does not supplant or exclude common law agency principles as theory of recovery under Securities Exchange Act); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 714 (2d Cir.) (stating that common law agency principles are available to plaintiff in action for securities violation), *cert. denied*, 449 U.S. 1011 (1980); Holloway v. Howerdd, 536 F.2d 690, 696 (6th Cir. 1976) (approving plaintiff's use of apparent authority to hold principal liable for securities violation); Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975) (holding that doctrine of respondeat superior is applicable to certain types of securities violations); Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975) (stating that liability for securities violations also arises from common law theories of vicarious liability); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 741 (10th Cir. 1974) (imposing liability upon principal through common law agency theory).

6. *See, e.g.*, *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 777 (9th Cir. 1984) (rejecting use of respondeat superior doctrine in action involving federal securities claim); Christoffel v. E. F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978) (stating that Ninth Circuit precedent holds that § 20(a) supplants doctrine of respondeat superior); Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir.) (holding that doctrine of respondeat superior is not available as basis of recovery for federal securities violation), *cert. denied*, 423 U.S. 1025 (1975); Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967) (applying § 20(a) to situation involving federal securities violation), *cert. granted*, 390 U.S. 942 (1968), *cert. dismissed* 393 U.S. 801 (1969).

7. *See* Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (adopting common law agency theory of vicarious liability for securities violations); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (approving apparent authority as theory of recovery for securities violations); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 777 (9th Cir. 1984) (stating that "controlling person" provision is exclusive source of vicarious liability for securities violations).

8. *See* Fitzpatrick & Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 1 (1983) (noting absence of Supreme Court review of exclusivity issue).

exclusive application of section 20(a) to securities violations.[9] Commentators have examined in detail the legislative history of section 20(a).[10] Analysis of the legislative history of section 20(a), however, is inconclusive on the question of exclusivity.[11] Congress based section 20(a) on section 15 of the Securities Act of 1933 (1933 Act).[12] Section 15 of the 1933 Act was created to prevent corporations from avoiding liability by using dummy agents.[13] Noting the atmosphere of increased securities regulation surrounding the drafting of the 1933 and 1934 Acts, commentators who support the application of common law remedies to securities violations argue that the effect of section 20(a) is to expand theories of liability to include situations previously outside the limits of traditional agency theory.[14] Commentators who favor applying the common law generally argue that the remedial nature of section 20(a) supports a theory of expansion of liability, rather

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9. *See, e. g.*, Black, *Application of Respondeat Superior Principles to Securities Fraud Claims Under the Racketeer Influenced and Corrupt Organizations Act (RICO)*, 24 SANTA CLARA L. REV. 825 (1984) (discussing relationship between common law remedies and § 20(a)); Fitzpatrick & Carman, *supra* note 7 (same); Musewicz, *Vicarious Employer Liability and Section 10(b): In Defense of the Common Law*, 50 GEO. WASH. L. REV. 754 (1982) (same); Note, *Third Circuit Adopts Limited Use of Respondeat Superior as Means of Imposing Secondary Liability Under Securities Exchange Act of 1934*, 55 TEMP. L.Q. 238 (1982) [hereinafter Note, *Third Circuit Adopts Limited Use*] (same); Note, *Rule 10b-5 — The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a) — Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383 (1982) [hereinafter Note, *10b-5 - The Equivalent Scope*] (same); Note, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CALIF. L. REV. 1513 (1981) [hereinafter Note, *Rule 10b-5 and Vicarious Liability*] (same); 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) [hereinafter Comment, *A Comparison of Control Person Liability*] (same); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward An Improved Analysis*, 126 U. PA. L. REV. 1345 (1978) [hereinafter Comment, *Secondary Liability*] (same); Comment, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713 (1974) [hereinafter Comment, *Vicarious Liability*] (same).

10. *See, e. g.*, Black, *supra* note 9, at 841-42 (discussing legislative history of § 20(a)); Fitzpatrick & Carman, *supra* note 8, at 22 (same); Note, *Third Circuit Adopts Limited Use*, *supra* note 9, at 261 (same); Comment, *Vicarious Liability*, *supra* note 9, at 718 (same).

11. *See supra* note 10 and accompanying text (stating that commentators argue for and against exclusivity based on legislative history of section 20(a)).

12. *See* 15 U.S.C. § 77(o) (1982) (1933 Act holds controlling persons liable to same extent as controlled actor, provided that controlling person had knowledge of or reason to believe in existence of facts giving rise to liability); *see also* Comment, *Vicarious Liability*, *supra* note 9, at 721 (discussing relationship between § 20(a) of 1934 Act and § 15 of 1933 Act).

13. *See* S. 785, 73d Cong., 1st Sess. § 2(k), 4, 13; 77 CONG. REC. 2979-82 (1933) (discussing purpose behind § 15 of 1933 Act).

14. *See* Black, *supra* note 9, at 842 (arguing that purpose of § 20(a) is to extend liability to persons beyond reach of common law); Note, *Vicarious Liability*, *supra* note 9, at 718 (stating that § 20(a) extends liability to situations lacking a master-servant or employer-employee relationship). Congress' purpose in drafting the Securities Acts, which was to prohibit

than a narrowing of available remedies.[15] Supporters of the availability of common law remedies also rely on section 28(a) of the 1934 Act, which states that remedies contained in the Act should be viewed as additions to remedies previously available.[16]

Rejecting the use of federal statutory remedies as additions to common law remedies, commentators arguing for exclusive application of section 20(a) contend that Congress, by including the good faith and inducement defenses in section 20(a), intended to replace common law notions of strict liability with the limited liability of section 20(a).[17] Common law agency theory imposes liability based on the relationship between a principal and an agent.[18] The liability of a principal does not depend on the personal fault of the principal.[19] As a result, the use of a strict liability standard renders useless the defenses available to a principal under section 20(a).[20] Because of the inconsistency between the strict liability standard and the available defenses under section 20(a), commentators argue that Congress must have intended section 20(a) to preempt the common law theory.[21]

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stock market abuses, suggests that the purpose of the "controlling person" provisions is to expand the ability of investors to hold employers liable for securities violations. Musewicz, *supra* note 9, at 791. Congress deliberately failed to define "control" within the statute in an effort to encompass the broadest range of relationships involving control. Note, *Vicarious Liability*, *supra* note 9, at 718.

15. *See* Black, *supra* note 9, at 842 (arguing that remedial nature of Securities Act supports use of common law theory); Note, *Third Circuit Adopts Limited Use*, *supra* note 9, at 250 (same).

16. *See* Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980) (language of § 28(a) of 1934 Act supports use of common law remedies). Section 28(a) of the Securities and Exchange Act of 1934 provides in part that:

> . . . the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

15 U.S.C. § 78(b)(b)(a) (1982).

17. *See* Black, *supra* note 9, at 841-42 (use of respondeat superior doctrine nullifies good faith defense in § 20(a)); Fitzpatrick & Carman, *supra* note 8, at 11 (same); *supra* note 2 and accompanying text (section 20(a) allows principals to invoke defenses of good faith and inducement). Because application of the respondeat superior doctrine in determining an employer's vicarious liability involves only the question of whether an employee acted within the scope of employment, consideration of the statutory defenses of good faith and inducement is irrelevant under common law analysis. Fitzpatrick & Carman, *supra* note 9, at 11. Commentators, therefore, argue that by including the statutory defenses in § 20(a), Congress rejected the use of common law remedies. Black, *supra* note 9, at 841-42.

18. *See supra* note 3 and accompanying text (under common law agency theory, liability arises from principal-agent relationship).

19. *See* RESTATEMENT (SECOND) OF AGENCY §§ 219, 229 (1958) (discussing lack of culpability of principal under doctrine of respondeat superior); *see also* Comment, *Vicarious Liability*, *supra* note 9, at 714 (discussing standards of principal liability).

20. *See* Fitzpatrick & Carman, *supra* note 8, at 1-2 (stating that use of common law agency theory nullifies exculpatory provisions of § 20(a)); Black, *supra* note 9, at 841-42 (discussing effect of respondeat superior doctrine in nullifying good faith defense in § 20(a)).

21. *See supra* notes 17 & 20 and accompanying text (commentators urge exclusivity of § 20(a) based on congressional intent to provide statutory defenses not available at common law).

In addition to analyzing the inconsistency between common law strict liability and the defenses available under section 20(a), commentators have examined Supreme Court opinions that address issues closely related to the exclusivity question.[22] While the Supreme Court has not addressed the issue of secondary liability, it has turned its attention to questions of primary liability.[23] In *Ernst & Ernst v. Hochfelder*,[24] the plaintiffs were customers of a small brokerage firm.[25] The brokerage firm retained the accounting firm of Ernst & Ernst to audit periodically the brokerage firm's books.[26] The president and majority shareholder of the brokerage firm had secured the plaintiffs' investment in a fraudulent scheme.[27] The plaintiffs, upon discovery of the fraud, filed an action against Ernst & Ernst, charging that the accounting firm had aided and abetted the brokerage firm's fraudulent scheme.[28] The plaintiffs alleged that Ernst & Ernst was negligent in failing to use proper auditing procedures that would have revealed the fraudulent activity within the brokerage firm.[29] The Supreme Court addressed the question of whether negligence was a sufficient basis for a cause of action under section 10-b of the 1934 Act, or whether section 10-b required a finding of intentional conduct.[30] The Court analyzed the language and the legislative history of section 10-b and concluded that section 10-b requires that conduct constituting a violation must include some element of intent.[31]

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22. *See* Fitzpatrick & Carman, *supra* note 8, at 14 (discussing recent Supreme Court decisions rejecting use of respondeat superior doctrine); Musewicz, *supra* note 9, at 756 (discussing recent Supreme Court cases concluding that Court has not resolved secondary liability issue).

23. *See, e. g.*, Herman & MacLean v. Huddleston, 103 S. Ct. 683, 686 (1983) (holding that implied remedy under § 10(b) was available for misrepresentations in registration statement in spite of express statutory remedy); American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., 456 U.S. 556, 570 (1982) (approving apparent authority as appropriate remedy for antitrust violations); Aaron v. SEC, 446 U.S. 680, 691 (1980) (extending to Securities and Exchange Commission actions requirement of intent as element of § 10-b claim).

24. 425 U.S. 185 (1976).

25. *Id.* at 189.

26. *Id.* at 188. In *Hochfelder*, Ernst & Ernst, in addition to auditing the brokerage firm's books, also prepared the firm's annual reports for filing with the Securities and Exchange Commission. *Id.*

27. *Id.* at 189. In *Hochfelder*, the president of the brokerage firm induced the plaintiffs to invest in escrow accounts, which the broker promised would yield high returns. *Id.* No escrow accounts existed, however, and the firm president was converting the money to his own use. *Id.*

28. *Id.* at 189-90.

29. *Id.* at 190. The plaintiffs in *Hochfelder* contended that Ernst & Ernst should have questioned the firm president's rule that only the president was authorized to open mail that he received at the firm. *Id.* The existence of the rule should have been reflected in Ernst & Ernst's reports as preventing an effective audit, thus leading the Securities and Exchange Commission to investigate the firm. *Id.*

30. *Id.* at 195. Section 10-b of the Securities Exchange Act of 1934 prohibits broadly the use of deception or manipulation in connection with the purchase or sale of securities. 15 U.S.C. § 78j (1982).

31. *Hochfelder*, 425 U.S. at 214-15.

While useful only for purposes of determining the general view of the Court regarding secondary liability, *Hochfelder* indicates that the United States Supreme Court is unwilling to impose primary liability upon principals without a finding of scienter.[32] Proponents of section 20(a) exclusivity argue that the intent requirement of section 10-b indicates that the Court would be opposed to the use of common law theories that employ a strict liability standard and require no finding of fault on the part of the principal.[33] A comparison of the nature of primary liability, which requires a finding of culpability, with secondary liability weakens the proponents' contention because secondary liability is distinguished by the absence of a direct fault requirement.[34] Supporters of exclusivity, however, also argue that the Supreme Court has rejected a theory of expanding remedies under federal securities laws based merely on the general remedial purposes of the laws.[35]

A United States Supreme Court decision subsequent to *Hochfelder* demonstrates the Court's willingness to employ the theory of apparent authority in cases of secondary liability.[36] In *American Society of Mechanical Engineers v. Hydrolevel Corp.*,[37] the Court addressed the liability of an organization, which promulgates industry safety codes, for antitrust violations of subcommittee members of the organization.[38] The American Society of Mechanical Engineers (ASME) publishes over 400 codes for different areas of engineering and industry.[39] The codes are advisory only, but have been incorporated in various federal regulations, state laws, and city ordinances.[40] Acting as an agent of ASME, a subcommittee of ASME was

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32. *See id.* (holding that scienter is necessary element in 10b-5 suit).

33. *See* Fitzpatrick & Carman, *supra* note 8, at 26 (contending that recent Supreme Court decisions indicate that Court favors finding of fault as prerequisite to liability under securities laws).

34. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 600 (1972) (comparing primary and secondary liability of principals for securities violations). Principals who owe a direct duty to injured parties are primarily liable for violations of the duty. *Id.* at 604. A principal is primarily liable for recklessly giving orders to employees, recklessly hiring employees, or for failing to perform a non-delegable duty. *Id.* Secondary liability, conversely, is liability of a principal that arises because an agent has violated the law. *Id.* at 600. Secondary liability involves the liability of a principal for the acts of agents in the absence of a principal's direct participation in the prohibited conduct. *Id.* at 604.

35. *See* Touche Ross & Co. v. Reddington, 442 U.S. 560, 578 (1979) (stating that remedial purpose of 1934 Securities Act does not justify reading provision of Act more broadly than language and statutory scheme permit); Fitzpatrick & Carman, *supra* note 8, at 26 (arguing that Supreme Court would be unwilling to accept use of common law remedies solely because of remedial nature of securities laws).

36. *See* American Soc'y of Mechanical Eng'rs v. Hydrolevel Corp., 456 U.S. 556, 559 (1982) (applying doctrine of apparent authority to vicarious liability claim under federal antitrust law).

37. 456 U.S. 556 (1982).

38. *Id.*

39. *Id.* at 559

40. *Id.*

responsible for issuing the Boiler and Pressure Vessel Code (Code), and for responding to specific public inquiries about the standards set in the Code.[41] One company, McDonnell & Miller, Inc. (M & M), had dominated the market for safety devices used in water boilers.[42] A competitor, Hydrolevel Corp., however, had developed a different model of the device and had attracted some of M & M's previous customers.[43] The vice-president of M & M also occupied the position of vice-chairman of the Boiler and Pressure Vessel Code subcommittee and used his influence to have the subcommittee determine that Hydrolevel's new device did not meet safety standards.[44]

Upon discovery of the subcommittee's actions, Hydrolevel filed suit in the United States District Court for the Eastern District of New York, alleging antitrust violations.[45] At trial, Hydrolevel requested a jury instruction stating that ASME was liable for the conduct of its agent subcommittee if the subcommittee was acting within the scope of its apparent authority.[46] The district court, however, held that ASME was liable only if ASME had ratified the agent's conduct or if the agent had acted to further the interests of ASME.[47] On appeal, the United States Court of Appeals for the Second Circuit held that ASME was liable if the agent had acted within the scope of the agent's apparent authority.[48] On appeal to the United States Supreme Court, the Supreme Court agreed with the Second Circuit's conclusion that the principles of agency law promoted the purposes of antitrust law, and thus apparent authority was available to hold ASME vicariously liable for the acts of the subcommittee.[49] The Court held that the subcommittee possessed the apparent authority to make representations because the business of the organization would be ineffective if industry could not rely on the subcommittee's codes.[50] In adopting the apparent authority theory, the Court reasoned that application of the principle of apparent authority was consistent with the remedial purpose of the antitrust laws.[51] The Court further stated that apparent authority is an accepted principle in the federal judicial system.[52] While *Hydrolevel* addresses antitrust violations rather than securities violations, the Court, after applying the principle of apparent author-

41. *Id.* at 560.
42. *Id.*
43. *Id.*
44. *Id.* at 560-61.
45. *Id.* at 564.
46. *Id.*
47. *Id.*
48. Hydrolevel Corp. v. American Soc'y of Mechanical Eng'rs, 635 F.2d 118, 124-27 (2d Cir. 1980) (approving use of apparent authority as source of vicarious liability for federal antitrust violation).
49. 456 U.S. at 567.
50. *Id.*
51. *Id.* at 570.
52. *Id.* at 567.

ity, noted and approved decisions that imposed liability for securities violations.[53]

In addition to citing Supreme Court decisions that lend support to the use of common law remedies for securities violations, supporters of common law remedies argue that the Securities and Exchange Commission (SEC) has stated consistently that it supports the use of common law remedies.[54] While the SEC's position is influential, SEC rulings are not controlling in the federal courts.[55] The SEC, however, continues to use the common law in its proceedings, and continues to urge the federal courts to allow plaintiffs to recover under the common law.[56]

Against the background of intense yet inconclusive analysis of the exclusivity of section 20(a), three federal circuits recently have decided cases involving apparent authority.[57] While the decisions do not resolve the dilemma of exclusivity, the decisions represent an initial step toward uniformity.[58] In *Hatrock v. Edward D. Jones & Co.*,[59] the Ninth Circuit maintained its position as the sole circuit favoring the exclusive application of section 20(a).[60] *Hatrock* involved a claim by customers of a brokerage firm against the firm and a broker-agent for misrepresentation and churning.[61] The plaintiffs were a young couple with little experience in the securities market.[62] The broker-agent induced the plaintiffs to buy and sell stocks by making representations that the broker had received information on the market from an inside source.[63] The plaintiffs filed suit in the United

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53. *Id.* at 568; *see* Holloway v. Howerdd, 536 F.2d 690, 696 (6th Cir. 1976) (approving apparent authority as basis of recovery for securities violations); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 741 (10th Cir. 1974) (imposing liability upon principal for securities violation through common law agency theory).

54. *See* Comment, *Vicarious Liability*, *supra* note 9, at 722 n.51 (discussing SEC's continued use of respondeat superior doctrine in cases involving vicarious liability for securities violations).

55. *See id.* (stating that SEC's position on use of respondeat superior doctrine is not binding on courts).

56. *See* Note, *Third Circuit Adopts Limited Use*, *supra* note 9, at 251 n.86 (discussing SEC's application of respondeat superior doctrine to securities violations).

57. *See* Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (approving use of apparent authority as source of vicarious liability for securities violation); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (same); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 777 (9th Cir. 1984) (rejecting use of all common law theories of vicarious liability for securities violations); *see also infra* notes 130-46 and accompanying text (analyzing effect of recent federal circuit court cases decided under theory of apparent authority).

58. *See infra* notes 130-46 and accompanying text (discussing effect of *In re Atlantic*, *Commerford*, and *Hatrock* decisions).

59. 750 F.2d 767 (9th Cir. 1984).

60. *See* Commerford v. Olson, 794 F.2d 1319, 1322 (8th Cir. 1986) (identifying Ninth Circuit as sole circuit adopting exclusive use of § 20(a)).

61. *Hatrock*, 750 F.2d at 770. Churning occurs when a broker initiates excessive trading of a customer's securities for the broker's personal gain. BLACK'S LAW DICTIONARY 220 (5th ed. 1979).

62. *Hatrock*, 750 F.2d at 770.

63. *Id.*

States District Court for the District of Idaho seeking recovery under federal and state securities laws as well as the state common law of fraud and misrepresentation.[64] The district court awarded the plaintiffs compensatory and punitive damages, but denied the plaintiffs attorney's fees.[65]

On appeal, the United States Court of Appeals for the Ninth Circuit affirmed the award of punitive damages based on the state common law claim.[66] The Ninth Circuit also upheld the award of compensatory damages.[67] The court, however, rejected the plaintiffs' contention that the common law theory of respondeat superior allowed the plaintiffs to collect attorney's fees incurred in pursuit of the federal securities claims.[68] In deciding the case, the Ninth Circuit did not examine the issue of section 20(a) exclusivity, but rather stated without additional comment that long-standing precedent in the Ninth Circuit prohibited the use of common law remedies.[69]

The persuasiveness of the Ninth Circuit prohibition against the use of common law remedies weakens upon examination of the prior Ninth Circuit cases.[70] In *Kamen & Co. v. Paul H. Aschkar & Co.*,[71] the Ninth Circuit did not analyze expressly the exclusivity issue, but rather stated that the principal was liable under neither traditional agency principles nor "controlling person" statutes.[72] *Kamen* involved two employees of a securities firm who headed the firm's broker-dealer division.[73] The employees had developed a fraudulent scheme, the purpose of which allegedly was to increase the firm's profits.[74] The employees would contact over-the-counter broker-dealers and request that the over-the-counter dealers direct listed stock transactions toward the Kamen firm.[75] In exchange, Kamen would channel its unlisted business to the over-the-counter firms.[76] The employees facilitated the scheme by creating a valueless stock in which to trade.[77] The

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64. *Id.*

65. *Id.*

66. *Id.* at 771.

67. *Id.* at 774.

68. *Id.* at 777.

69. *Id.*; *see* Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 696 (9th Cir. 1967) (Ninth Circuit rejects use of ostensible authority as basis of remedy for securities violation); Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (Ninth Circuit relies on *Kamen* decision to prohibit use of common law remedies for securities violations).

70. *See In re Atlantic*, 784 F.2d at 34 (discussing weaknesses of Ninth Circuit precedent regarding exclusivity issue); *infra* notes 72-93 and accompanying text (same).

71. 382 F.2d 689 (9th Cir. 1967).

72. *Id.* at 696; *see supra* notes 2 & 3 and accompanying text (discussing common law agency principles and "controlling person" statutes).

73. *Kamen*, 382 F.2d at 691.

74. *Id.* at 692.

75. *Id.* Rules of various stock exchanges require generally that stocks listed on a certain exchange be purchased only by members of that exchange. *Id.* at 691 n.2.

76. *Id.*

77. *Id.* In *Kamen*, the employees would contact one broker-dealer and request that he purchase the valueless shares from a second broker-dealer and in turn sell the shares to a third broker-dealer at a slightly higher price. *Id.* The employees thus developed a chain of sales at increasing prices. *Id.*

plaintiff, an over-the-counter firm, brought suit against the employer under both section 20(a) and common law agency principles.[78] The United States District Court for the Southern District of California found the employer liable on a theory of ostensible authority and awarded damages to the plaintiff.[79] The trial court found the existence of an agency relationship between the employer and employees based on the employment relationship and the employees' status as managers of the broker-dealer division.[80] The *Kamen* court determined that the employees had actual authority to solicit transactions involving listed stocks and had ostensible authority to make representations and to carry out the listed transactions.[81] The district court also found that the plaintiff reasonably relied on the ostensible authority of the employees.[82] The defendant appealed the district court's final judgment.[83]

On appeal, the United States Court of Appeals for the Ninth Circuit found that the plaintiff's reliance upon the alleged authority of the employees was unreasonable in light of the plaintiff's experience in and knowledge of the securities field.[84] Consequently, the Ninth Circuit found no ostensible authority, and thus the plaintiff could not recover under agency principles.[85] The *Kamen* court further exonerated the employer of liability under section 20(a) because the employer acted in good faith and did not induce the employees' conduct.[86]

In a decision subsequent to *Kamen*, the Ninth Circuit upheld the *Kamen* rule that section 20(a) is the proper standard for determining a principal's liability for federal securities violations.[87] In *Zweig v. Hearst Corp.*,[88] the plaintiffs brought suit against a newspaper publisher for the misrepresentations of a reporter in his financial column.[89] The court rejected the use of the respondeat superior doctrine based on the precedent that *Kamen* had set.[90] The *Zweig* court, however, after stating that the "controlling person" remedy in section 20(a) is the only source of employer liability for securities

78. *Id.* at 693.

79. *Id.* The *Kamen* court uses the term ostensible authority, which is synonymous with apparent authority. *Id.* at 695.

80. *Id.* at 693.

81. *Id.* at 693-94.

82. *Id.*

83. *Id.* at 690.

84. *Id.* at 696. The *Kamen* court stated that the fraudulent transactions were sufficiently unusual in the securities market to put the plaintiff on notice that an inquiry into the agents' authority might be warranted. *Id.*

85. *Id.*

86. *Id.* at 697.

87. *See* Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir. 1975) (adopting *Kamen* rule that § 20(a) supplants common law vicarious liability).

88. 521 F.2d 1129 (9th Cir. 1975).

89. *Id.* at 1131. In *Zweig*, the financial reporter wrote an article that falsely painted an attractive financial picture of a company in which the reporter owned stock. *Id.* When the price of the company's stock rose as a result, the reporter sold his stock at a profit. *Id.*

90. *Id.* at 1132-33.

violations, found the newspaper publisher to be a controlling person, but recognized that the newspaper publisher could not be held to a broker-dealer standard that required the employer to maintain and enforce a reasonable and proper system of control over employees.[91]

The lack of apparent authority in *Kamen* and the lowered standard of control in *Zweig* constitute factual differences that weaken the foundation of the Ninth Circuit's blanket rejection of common law remedies.[92] The Ninth Circuit's use of cases lacking true apparent authority characteristics to establish precedent on the issue of the exclusivity of section 20(a) explains the Ninth Circuit's position as the single jurisdiction favoring total exclusivity of section 20(a).[93]

Unlike the Ninth Circuit decisions in *Kamen* and *Zweig*, the United States Court of Appeals for the Eighth Circuit, in *Commerford v. Olson*,[94] affirmed the use of common law theory in circumstances that involved apparent authority.[95] In *Commerford*, the plaintiff had agreed to invest her money on the advice of a bond salesman in the employ of defendant bond firm.[96] The plaintiff had sent several checks to the salesman.[97] In return, the salesman sent the plaintiff infrequent and irregular payments allegedly representing interest income.[98] Rather than investing the plaintiff's money, the salesman had been converting the money to his personal use.[99]

The salesman was on an extended leave of absence from the defendant

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91. *Id.* at 1134-35.

92. *See supra* notes 71-91 and accompanying text (demonstrating that failure of Ninth Circuit to engage in apparent authority analysis is due to existence of factual situations not supporting apparent authority relationships).

93. *See* Christoffel v. E. F. Hutton & Co., Inc., 588 F.2d 665, 667 (9th Cir. 1978) (adopting Ninth Circuit precedent that states that § 20(a) is exclusive remedy for securities violations). In *Christoffel*, an account executive for a brokerage firm assumed a position as guardian for an investor who had become incompetent. *Id.* at 666. The employee converted the investor's funds to his own use. *Id.* at 667. The investor's subsequent guardian brought an action against the brokerage firm based on the employment relationship that existed during the guardianship. *Id.* Relying on precedent, the Ninth Circuit rejected the use of common law theories and also found that the brokerage firm was not a controlling person under § 20(a) because the firm did not participate in the employee's guardian activities. *Id.* at 669; *see* Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 696 (Ninth Circuits rejects ostensible authority as basis of remedy for securities violation); Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (Ninth Circuit prohibits use of common law remedies for securities violations); *see also supra* notes 71-91 and accompanying text (circumstances in Ninth Circuit decisions did not indicate existence of apparent authority).

94. 794 F.2d 1319 (8th Cir. 1986).

95. *Id.* at 1323.

96. *Id.* at 1320. In *Commerford*, plaintiff was a retired librarian investing the proceeds from the sale of her house. *Id.* The salesman was the plaintiff's nephew. *Id.* The plaintiff, having no experience in the securities market, relied on her nephew's advice. *Id.*

97. *Id.* at 1321. In *Commerford*, the plaintiff made her checks payable to the salesman personally. *Id.*

98. *Id.* In *Commerford*, the salesman sent plaintiff interest checks drawn on his personal bank account.

99. *Id.*

brokerage firm during the time of the fraudulent activity.[100] The plaintiff attempted to reach the salesman at the defendant's office during this period, but the defendant told the plaintiff that the salesman was on a leave of absence.[101] The defendant brokerage firm did not know of the salesman's fraud.[102] Similarly, the plaintiff did not know that securities industry regulations prohibit employees on a leave of absence from conducting lawful securities transactions.[103]

The plaintiff filed an action in the United States District Court for the District of Minnesota, alleging violations of state and federal securities laws, as well as common law fraud, breach of contract, and vicarious liability.[104] The district court entered judgment in favor of the bond firm.[105] The United States Court of Appeals for the Eighth Circuit reversed the decision of the district court, holding that common law apparent authority is a basis for recovery for securities violations.[106]

In holding that section 20(a) does not preempt apparent authority as an available basis of recovery for securities violations, the Eighth Circuit recognized the split among the circuits on the issue of applicability of common law agency principles to securities violations.[107] The court then aligned itself with the circuits that allow the use of agency remedies.[108] The court reasoned that the purpose of section 20(a) was not to narrow existing remedies.[109] Supporting its statement, the court offered the language of section 28(a) that the rights and remedies of the 1934 Act are in addition to existing rights and remedies as evidence that section 20(a) operates to expand available remedies.[110] The Eighth Circuit, however, limited its decision to cases involving actual or apparent authority.[111] Under the Eighth Circuit's reasoning, the scope of a principal's vicarious liability is limited to either a grant of actual authority or a principal's act of holding out an agent as a party that is authorized to act for the principal.[112] Both actual

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100. *Id.*

101. *Id.*

102. *Id.* During the salesman's leave of absence, the defendant brokerage firm in *Commerford* discovered that the salesman had converted to his own use investment funds received from his in-laws in a separate transaction. *Id.* The firm terminated the salesman's employment and cancelled his license to sell bonds. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at 1320.

106. *Id.* The Eighth Circuit in *Commerford* held that the district court's failure to submit a special verdict on apparent authority was in error and remanded the case for a new trial. *Id.* at 1324.

107. *Id.* at 1322; *see supra* notes 3-8 and accompanying text (discussing split among circuits on exclusivity issue).

108. *Commerford*, 794 F.2d at 1323; *see supra* note 5 and accompanying text (listing circuits that allow use of agency remedies).

109. *Commerford*, 794 F.2d at 1323.

110. *Id.*; *see supra* note 16 (discussing provisions of § 28(a) of 1934 Act).

111. *Commerford*, 794 F.2d at 1323.

112. *Id.*

and apparent authority require some action of a principal.[113] The Eighth Circuit's approval of apparent authority, thus, does not subject a principal to strict liability for the acts of an agent.[114]

In approving the use of apparent authority as the basis of a remedy for securities violations, the United States Court of Appeals for the First Circuit reached a decision similar to the Eighth Circuit's decision in *Commerford*.[115] In *In re Atlantic Financial Management, Inc.*,[116] the plaintiffs had alleged that the defendant corporation's chairman had misrepresented facts about the corporation.[117] The misrepresentation had induced plaintiffs to purchase stock in the corporation and, when stock prices fell, caused plaintiffs to suffer a loss.[118] Plaintiffs brought suit in the United States District Court for the District of Massachusetts.[119] The district court found that the "controlling person" section of the 1934 Act did not preclude use of apparent authority.[120] In affirming the district court's decision, the First Circuit confronted the critical issue of whether section 20(a) is the exclusive remedy for securities violations.[121]

In addressing the exclusivity question, the First Circuit analyzed different agency relationships including actual authority, apparent authority, and inherent authority.[122] The First Circuit characterized the circumstances in question, involving a high-ranking corporate officer, as falling within the apparent authority category.[123] In determining that section 20(a) is not an exclusive remedy, the court effected its own analysis of the legislative history of section 20(a) and concluded that the purpose of the section is to expand rather than restrict liability for violations of federal securities laws.[124] In a narrow holding, the court approved the applicability only of the principle of apparent authority as a basis of recovery for securities violations.[125] In

113. *See supra* note 3 and accompanying text (discussing action required of principal in situations involving apparent authority).

114. *See Commerford*, 794 F.2d at 1323 (premising liability of principal upon proof of actual or apparent authority).

115. *See* Commerford v. Olson, 794 F.2d 1319, 1323 (9th Cir. 1986) (holding that apparent authority is appropriate remedy for securities violations); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (same).

116. 784 F.2d 29 (1st Cir. 1986).

117. *Id.* at 30.

118. *Id.*

119. *Id.* at 29.

120. *Id.*

121. *Id.* at 31-32.

122. *Id.* at 32. The *Atlantic* court discussed three types of agency relationships. *Id.* A principal actually may authorize an agent to act. *Id.* Actual authority may be either express or implied. *Id.* Secondly, apparent authority exists when an agent appears to third parties to possess authority. *Id.* A principal may also be liable to third parties based on the authority that the agent appears to possess by reason of the agent's position, which is known as inherent authority. *Id.*

123. *Id.* at 33.

124. *Id.* at 35; *see supra* notes 10-21 and accompanying text (discussing legislative history of § 20(a)).

125. *See In re Atlantic*, 784 F.2d at 35 (limiting holding to circumstances involving apparent authority).

explaining the narrow scope of its ruling, the First Circuit stated that the use of common law theory in conjunction with federal statutes depends on the common law's consistency with the language of the federal statute and with the purpose underlying the statute.[126] According to the First Circuit, the use of agency law is thus appropriate only when agency law promotes the purposes of the securities laws.[127] In adopting the principle of apparent authority, the First Circuit relied on the United States Supreme Court's decision in *American Society of Mechanical Engineers v. Hydrolevel Corporation*, which approved apparent authority as the basis of a claim under federal antitrust law.[128] Like *In re Atlantic*, *Hydrolevel* involved the use of common law apparent authority as a basis for imposing liability upon a principal for a federal statutory violation.[129]

The decisions of the First Circuit in *In re Atlantic* and the Eighth Circuit in *Commerford* allow a recovery based on common law agency only in situations involving apparent authority.[130] The Ninth Circuit's decision in *Hatrock* rejects common law agency theory based on precedent that lacks a factual basis for finding an apparent authority relationship.[131] While *Commerford*, *In re Atlantic*, and *Hatrock* do not settle completely the confusion surrounding the exclusivity issue, the decisions represent an explanation of the existing conflict between circuits and the beginning of a judicial effort to adopt a compromise position.[132] The decisions do not embrace totally the concept of recovery based on the doctrine of respondeat superior.[133] The doctrine of respondeat superior requires only that an employee act within the scope of employment to subject a principal to liability for actions of the employee.[134] Unlike courts that apply the respondeat superior doctrine, the courts in *In re Atlantic* and *Commerford* adopt the principle of apparent authority.[135] Apparent authority requires that the

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126. *Id.*

127. *Id.*

128. *Id.* at 31; *see supra* notes 36-53 and accompanying text (discussing *Hydrolevel* decision).

129. *See* American Soc'y of Mechanical Eng'rs v. Hydrolevel Corp., 456 U.S. 556, 567 (1982) (Supreme Court holds that apparent authority is appropriate basis for imposing vicarious liability on principal for federal antitrust violations).

130. *See supra* notes 94-128 and accompanying text (discussing *In re Atlantic* and *Commerford* decisions, which were based on circumstances involving apparent authority).

131. *See supra* notes 71-91 and accompanying text (arguing that Ninth Circuit precedent rejects use of apparent authority doctrine based on cases the facts of which lack elements of apparent authority).

132. *See infra* notes 133-46 and accompanying text (arguing that *In re Atlantic* and *Commerford* decisions represent move toward uniformity among circuits on exclusivity issue).

133. *See supra* notes 111-14 & 125-28 and accompanying text (stating that First and Eighth Circuit holdings are limited to circumstances involving actual and apparent authority).

134. *See supra* note 3 and accompanying text (discussing elements of respondeat superior doctrine).

135. *See supra* notes 111-14 & 125-28 and accompanying text (discussing First and Eighth Circuit recognition of apparent authority in cases involving vicarious liability for securities violations).

principal hold the agent out to third parties as one authorized to act for the principal and further requires that the third party actually rely on the representation.[136] The *In re Atlantic* and *Commerford* decisions represent a judicial determination to adhere to common law recovery and simultaneously retreat from common law strict liability.[137]

By requiring a principal's holding out of an agent's authority, together with a third party's reliance on the representation of authority, the application of apparent authority as a basis of recovery for securities violations provides some protection of principals against unlimited liability for the acts of employees.[138] The First and Eighth Circuits, in adopting the apparent authority principle as a basis of recovery, have attempted to strike a balance between completely abandoning long-standing common law bases of liability and holding principals strictly liable for the acts of employees.[139] Judicial approval of apparent authority as a source of a principal's vicarious liability combines the underlying policies of both common law agency and section 20(a).[140] The common law doctrine of respondeat superior allows plaintiffs greater recovery by holding principals strictly liable for the conduct of a principal's agents.[141] Conversely, section 20(a) severely restricts the ability of plaintiffs to recover against principals by offering principals the broad defenses of good faith and lack of inducement.[142] The apparent authority principle occupies a middle ground between the doctrine of respondeat superior and section 20(a).[143] The theory of apparent authority protects the principal by requiring a representation of authority by the principal, yet the protection of the principal under the apparent authority theory is not as broad as that of section 20(a), which offers the good faith and lack of inducement defenses.[144] The principle of apparent authority, therefore, allows plaintiffs greater recovery than does section 20(a), but also offers

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136. *See supra* note 3 and accompanying text (discussing requirements of apparent authority).

137. *See* Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (holding that actual and apparent authority give rise to liability of principal in securities violation claim); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (holding that apparent authority is proper basis of remedy for securities violations); *see also supra* note 3 and accompanying text (discussing common law agency principles).

138. *See* Paul F. Newton v. Texas Commerce, 630 F.2d 1111, 1119 (5th Cir. 1980) (stating that use of actual or apparent authority restricts scope of principal's vicarious liability).

139. *See supra* notes 132-38 and accompanying text (discussing effect of *In re Atlantic* and *Commerford* decisions).

140. *See infra* notes 141-45 and accompanying text (discussing effect of use of apparent authority as basis of recovery for securities violations).

141. *See supra* note 3 (stating that liability under respondeat superior doctrine requires no fault on part of principal).

142. *See supra* note 2 (stating that § 20(a) includes broad defenses of good faith and inducement).

143. *See supra* note 3 (discussing reqiurements of apparent authority principle).

144. *See id.* (comparing elements of apparent authority doctrine and § 20(a)).

principals greater protection than does the doctrine of respondeat superior.[145] The compromise position that the United States Courts of Appeals for the Eighth Circuit and First Circuit have adopted is an initial effort to create a flexible and workable solution to the dilemma of determining a plaintiff's proper basis of recovery for federal securities violations.[146]

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145. *See supra* notes 2 & 3 (describing defenses in § 20(a) and elements of apparent authority principle and respondeat superior doctrine).

146. *See* Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (stating that apparent authority is appropriate basis of recovery for securities violation); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986) (holding that vicarious liability for securities violation is properly based upon apparent authority).