
THE BUCK STOPS WHERE?: DEFINING CONTROLLING PERSON LIABILITY

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I. INTRODUCTION

From 1929 to 1933, the securities markets lost half of their value, a startling 20% of the workforce was unemployed, and productivity was 50% less than it had been in previous years. As the United States grappled with the Great Depression, it asked why such catastrophes had happened. It became apparent that the structural flaws of Wall Street—that is, its anemic self-regulation—deserved a large part of the blame.¹ Congress sought to implement legislation in the form of the Securities Act of 1933 and Exchange Act of 1934, which would prevent such a catastrophe from ever occurring again. These statutes established liability for those who commit securities fraud, and were designed to restore investor confidence in a badly shaken market. These Acts went even further, however, by creating liability for those who “control” the company behind the scenes. Section 15 of the 1933 Act and Section 20(a) of the 1934 Act established that the “controlling person” of the entity responsible for the primary securities violation would be secondarily liable.

Unfortunately, Congress left much unsaid in the text of the statutes. Courts have had to decide whether these statutes were meant to supplant existing common law principles of agency and respondeat superior, or merely provide an alternate source of liability. Eventually they concluded that controlling person liability was meant to reach those individuals who

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1. See ALAN R. PALMITER, *SECURITIES REGULATION: EXAMPLES AND EXPLANATIONS* 17-20 (1998).

would not incur liability under an alternate theory of liability. Courts have also been left to define the meaning of “control.”

This Note is concerned with the fundamental question of the definition of “control.” Part II of this Note details Sections 15 and 20(a) of the Acts, and discusses, in detail, the deficiencies of both. It then discusses the Securities and Exchange Commission’s definition of control. Part III of this Note examines the three methods—control by status, culpable participation, and potential control—that have been used to determine control. It also examines recent decisions of both the circuit courts and district courts to show that even within a circuit, federal courts are applying the concept of control inconsistently. Finally, Part IV of this Note argues that the courts are wisely edging away from the culpable participation doctrine towards potential control and suggests still other ways in which the courts could alleviate the quandary they now face in determining who controls.

II. SOURCES FOR SECONDARY LIABILITY

There are two statutory sources that impose secondary liability on “controlling persons” for securities laws violations. These two statutes, although substantively similar, may theoretically lead to different conclusions, although the courts usually treat them as synonymous.

A. THE SECURITIES ACT

The Securities Act of 1933 mandates that companies seeking to issue securities to the public file a registration statement with the Securities and Exchange Commission (“SEC”), distribute a prospectus, and it creates liability for misinformation in the registration statement, prospectus, or the distribution of the securities. Section 15 provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more persons by or through stock ownership, agency, or otherwise, controls any person liable sections 77(k) or 77(l) of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe the existence of the facts by reason of which the liability of the controlled person is alleged to exist.²

2. 15 U.S.C. § 77(o) (1994).

Section 77(k) creates civil liability for false registration statements,³ and Section 77(l) creates liability for information contained within prospectus and communications.⁴ An individual must be found to have violated one of the above sections for Section 15 to apply. There has been much debate among commentators, as well as among courts, as to whether Section 15 precludes the traditional common law application of respondeat superior as an alternative cause of action.⁵ Some feel that the language of Section 15 imposes liability for negligent behavior.⁶ Thus, only those controlling persons who have negligently performed their duty of control can be found liable.

B. THE EXCHANGE ACT

Because Section 15 of the Securities Act only pertains to the violation of Sections 77(k) and 77(l), it is of limited use to wronged shareholders. The Exchange Act regulates far more. Section 20(a) gives the shareholder additional redress against the controlling individual for securities violations committed by someone else. The relevant part states:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.⁷

Notably absent in this provision is a description of who “controls.” Whereas Section 15 gives some guidance as to types of controlling individuals—those who control through “stock ownership, agency, or otherwise”—who could be held liable, Section 20(a) is silent. “Every person” who controls any liable person under any other provision of the Exchange Act is potentially accountable. However, the characteristics of a controlling person are missing. By looking at the legislative history of the

3. 15 U.S.C. § 77(k) (1994).

4. 15 U.S.C. § 77(l) (1994).

5. See J. Christopher York, *Vicarious Liability of Controlling Persons: Respondeat Superior and the Securities Acts—A Reversible Consensus in the Circuits*, 43 EMORY L.J. 313, 314 (1993). Respondeat superior places strict liability upon the employer for tortious actions committed by employees or agents acting within the scope of employment. See *id.* at 325. This issue is not the focus of this Note.

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

7. 15 U.S.C.A. 78t(a) (1994).

two sections, it becomes clear that Congress intentionally omitted fixed criteria for defining a "controlling person."⁸ It was thought that by keeping the concept of control flexible, the statute would be applicable to a variety of situations both seen and unforeseen. Absent a bright line rule, however, the courts have been forced to wade through a sea of uncertainty to uncover who qualifies as a controlling person.

Furthermore, it appears that liability under Section 20(a) requires something more than negligence. In *Ernst & Ernst v. Hochfelder*,⁹ the Supreme Court stated in dictum that Congress intended that more than negligence was necessary to establish liability under Section 20(a).¹⁰ Commentators have surmised that Section 20(a) requires a successful showing of recklessness. The Second Circuit has interpreted the language in *Ernst & Ernst* to mean that the defendant must be in some way a culpable participant to be liable under Sections 15 and 20(a).

In contrast to Section 15 of the Securities Act, Section 20(a) of the Exchange Act allows for a "good faith defense." If the individuals charged acted in good faith, and did not induce the wrongdoing, they can then escape liability. Some courts have interpreted this defense as mandating scienter of the primary violation for Section 20(a) to apply.¹¹ Applying this theory, some courts have required that the individual be a culpable participant in the fraud committed by the controlled person.¹² The reasons behind such a holding and their merits will be discussed later in this paper.

C. THE SEC'S DEFINITION OF CONTROL

The SEC itself has issued a definition of control for the purposes of administrative proceedings, a definition that has been relied upon by the courts in varying degrees. The SEC has used the term "control" to define "the possession, direct or indirect, of the power to direct or cause the

8. See Carson, *supra* note 6, at 274 (citing H.R. REP. NO. 73-1383, at 26 (1934)).

9. 425 U.S. 185 (1976).

10. See *id.* at 209 n.28.

11. See, e.g., *Rochez Bros. v. Rhoades*, 527 F.2d 880, 885 (3d Cir. 1975); *Lanza v. Drexel*, 479 F.2d 1277 (2d Cir. 1973).

12. See *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). This case was the first to term the phrase culpable participation. The court stated en banc that "the intent of Congress in adding . . . [20(a)] . . . was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." *Id.* at 1299.

direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”¹³

Some courts cite directly to the SEC regulation when determining who is a controlling person.¹⁴ Most, however, find alternative reasoning in their determination of control and ignore the SEC’s definition altogether. Whatever the standard, however, the SEC’s interpretation of the Exchange Act serves as a backdrop for the discussion of control.

III. COMPETING THEORIES OF CONTROL

Three principal frameworks that provide a basis for analysis as to who is a “controlling person” have emerged from court opinions and commentators.

A. CONTROL BY STATUS

The first framework, “control by status,” determines who controls by looking at the individual’s position in the company and that person’s relationship with the person or entity liable for the primary violation. For an individual to control, the court does not need to determine whether the defendant actually controlled the violator or simply was in a position to do so.¹⁵ In *Salit v. Stanley Works*,¹⁶ Judge Dorsey stated that “the conclusion is inescapable that persons who act as directors are in control of the corporation.”¹⁷ By virtue of title or position, an individual controls the wrongdoer, albeit indirectly. This theory can lead, according to some, to rather harsh results. For instance, in *Moerman v. Zipco, Inc.*,¹⁸ all of the company’s directors were held responsible for the acts of the company president by virtue of their being in control of the company itself.¹⁹

Control by status has emerged in jurisdictions where potential control is the announced standard. In *In re Miller Industries, Inc.*²⁰ the district

13. 17 C.F.R. § 230.405 (1999) (Securities Act statute enacted in 1947); 17 C.F.R. § 240.12b-2 (1999) (Exchange Act statute enacted in 1948).

14. See *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957 (5th Cir. 1981); *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980); *Sheinkopf v. Stone*, 927 F.2d 1259, 1270 (1st Cir. 1991).

15. See Bradford R. Turner, *Recent Developments: Brown v. Enstar Group, Inc.: The Eleventh Circuit Opens the Door for Expansive Controlling Person Liability Under the 1933 and 1934 Securities Acts*, 32 GA. L. REV. 323, 334 (1997).

16. 802 F. Supp. 728 (D. Conn. 1992).

17. *Id.* at 734 (citing *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969)).

18. 302 F. Supp. 439 (E.D.N.Y. 1969), *aff’d*, 430 F.2d 362 (2d Cir. 1970).

19. 302 F. Supp. at 447.

20. 12 F. Supp. 2d 1323 (N.D. Ga. 1998).

court applied the *Brown* test and held that the defendants' position as officers and/or directors of Miller Industries enabled them to control the general affairs of the company, as well as have supervisory control over the publicly disseminated documents that were the heart of the primary violation.²¹ Nowhere in the opinion was a connection made as to how the individual defendants, by virtue of their positions alone, possessed the power to control the company. The court inferred that officers and directors necessarily control the general affairs of the company.

Control by status does not make any fact-specific inquiry into whether the defendant actually exercised authority. In fact, under the control by status approach, an individual accused under Sections 20(a) or 15 need not even possess the power to control the primary violator. Control is presumed if the individual occupies a position or status that "ordinarily conveys authority to control."²² Because of this, many commentators have decried the use of this standard. One such commentator called it "patently illogical to argue that a director qua director is necessarily in control."²³ Others believe that control by status is akin to strict liability in securities.²⁴ Section 20(a), however, presents a defense of good faith which would be unavailable to a person under a strict liability regime. Furthermore, status could be used merely as prima facie evidence of control. The presumption of control could be "rebuttable by a showing of a lack of authority in fact or that other persons controlled the primary violators to the exclusion of [the] defendant."²⁵

Several courts have used the control by status approach to determine whether a controlling person claim should survive summary judgment. In *Schaffer v. Timberland Co.*,²⁶ the court stated that a complaint survives summary judgment "where it alleges at a minimum the control status of the defendant, that 'the controlling person directly or indirectly held the power to exercise control over the primary violator.'"²⁷ In *Schaffer*, one of the defendants, Sidney Schwartz, held the positions of Chairman of the Board, President, and Chief Executive Officer. The other defendant, Jeffrey

21. *Id.* at 1333.

22. Carson, *supra* note 6, at 283.

23. Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1023 (1973).

24. See Shaun P. Kenney, Comment, *The Eighth Circuit and Secondary Liability Under the 1933 and 1934 Securities Acts—Metge v. Baehler*, 19 CREIGHTON L. REV. 887, 901 (1986).

25. Carson, *supra* note 6, at 283.

26. 924 F. Supp. 1298 (D.N.H. 1996).

27. *Id.* at 1322 (internal citations omitted).

Schwartz, was a board member, Executive Vice President, and Chief Operating Officer. The court did not look into whether or not these individuals influenced the primary entity's wrongdoing for the purpose of determining whether they were "controlling persons." Instead, fundamental to the court's holding was its view of the remedial nature of the Exchange Act. Because Section 20(a) is meant to protect shareholders, it should be "construed liberally when determining whether [an] individual defendant was a controlling person."²⁸

Some courts in the Second Circuit have also utilized control by status in limited circumstances. A Second Circuit case, *Marbury Management, Inc. v. Kohn*,²⁹ has been interpreted by some courts to mean that only control by status is necessary to establish a prima facie case for controlling person liability.³⁰ The court in *In re Health Management, Inc.* held that, although control by status may be adequate for overcoming a 12(b)(6) motion, something more was needed for proof at trial.³¹ A decision from the Northern District of Georgia also seems to incorporate control by status in at least part of its analysis. In *In re ValuJet, Inc.*,³² the court found controlling person liability where the plaintiffs asserted "that because of their management positions and/or positions as directors, the individual Defendants could control ValuJet's general affairs."³³ Thus, the court accepted the defendants' status as sufficient to overcome the first part of the *Brown* test. To satisfy the second part of the test, the court seems to have demanded more information. All of the defendants were in positions of power within the company and "disseminated information about ValuJet's safety and maintenance practices."³⁴ The causal link, therefore, must be much stronger in the second part of the test for liability to be triggered.

The Tenth Circuit also appears to use some variant of control by status. In *First Interstate Bank v. Pring*,³⁵ the court found that Pring was a controlling person by virtue of his position as a director and vice president

28. *Id.*

29. 629 F.2d 705 (2d Cir. 1980).

30. See *In re Health Management, Inc.*, 970 F. Supp. 192, 206 (E.D.N.Y. 1997). See also *Food and Allied Serv. Trades Dept., AFL-CIO v. Millfeld Trading Co.*, 841 F. Supp. 1386, 1390 (S.D.N.Y. 1994); *Borden, Inc. v. Spoor Behrins Campbell & Young, Inc.*, 735 F. Supp. 587, 591 (S.D.N.Y. 1990); *In re Citisource, Inc.*, 694 F. Supp. 1069, 1076 (S.D.N.Y. 1988).

31. 970 F. Supp. 192 at 206.

32. 984 F. Supp. 1472 (N.D. Ga. 1997).

33. *Id.* at 1480.

34. *Id.*

35. 969 F.2d 891 (10th Cir. 1992).

and his status as a twenty percent shareholder and five million dollar creditor of the corporation. The court felt that the facts led one to infer that he was in a position to exert at least indirect control.³⁶ In an earlier district court case the plaintiff's claim of essentially "control by status" passed muster for the pleading stage.³⁷ The plaintiff needs only to "give a defendant fair notice of the plaintiff's claim and the basis upon which it rests."³⁸

B. CULPABLE PARTICIPATION

Some courts have balked at applying the control by status doctrine because of the possible incongruence between the individual factual situation of the controlling person and the imposition of secondary liability. The culpable participation test has evolved as a response to what some see as the undue harshness of the control by status approach. The Second Circuit first imposed an additional burden upon the plaintiff in *Lanza v. Drexel & Co.*³⁹ In addition to merely showing that the defendant occupied a position of control, the plaintiff must show that the defendant was, "in some meaningful sense [a] culpable participant[] in the fraud perpetrated by controlled persons."⁴⁰ To require such a finding of culpable participation in the alleged wrongdoing effectively voids the statutory affirmative defenses of good faith and lack of inducement.⁴¹

The language in *Lanza* was reiterated in 1996 in a Second Circuit opinion, *SEC v. First Jersey Securities, Inc.*,⁴² which stated that culpable participation is an element in proving the prima facie case of control.⁴³ Perhaps because *First Jersey Securities* did not overrule previous cases that omitted culpable participation as a part of the prima facie case, it has not ended the debate on the issue in the Second Circuit. One recent case declined to decide whether culpable participation or scienter was necessary⁴⁴ and another held that lack of knowledge and culpability "constitute an affirmative defense."⁴⁵

36. *See id.* at 898.

37. *See In re Storage Tech. Corp.*, 147 F.R.D. 232, 236 (D. Colo. 1993).

38. *Id.*

39. 479 F.2d 1277 (2d Cir. 1973).

40. *Id.* at 1299.

41. *See Turner, supra* note 15, at 337.

42. 101 F.3d 1450 (2d Cir. 1996).

43. *See id.* at 1472-73. *But see* Food and Allied Serv. Trades Dept. v. Millfeld Trading Co., 841 F. Supp. 1386, 1390 (S.D.N.Y. 1994).

44. *See In re Fine Host Corp.*, 25 F. Supp. 2d 61, 73 (D. Conn. 1998) ("In addition, this court need not resolve the question of whether culpable conduct must be alleged . . . even if culpable conduct

The Second Circuit's theory of culpable participation soon was adopted by courts in other circuits.⁴⁶ The Third Circuit in *Rochez Bros. v. Rhoades* stated that "Congress intended [Section 20(a)] liability to be based on something besides control. That something is culpable participation."⁴⁷ Culpable participation need not be direct involvement in the wrongdoing, but the person must have consciously intended to aid in the wrongdoing.⁴⁸ The Third Circuit found support for its holding in the legislative history of Section 20(a) of the 1934 Act and Section 15 of the 1933 Act. The Senate favored a plan of "insurer's liability," whereby directors and officers were held to be strictly liable,⁴⁹ while the House of Representatives proffered a "fiduciary standard" which imposed liability only when the individual breached her duty of due care.⁵⁰

The adoption of the House version of the statute led the court to conclude that Congress did not intend the statutes to allow controlling persons to act as insurers for the wrongful deeds of another.⁵¹ Without a narrow interpretation of controlling person liability, it is argued, courts could hold controlling persons liable for any misdeed of its employees, past or present. Such strict liability is unlikely to deter future illegal activities.⁵² The Supreme Court added a modicum of support to this notion when, in *Ernst & Ernst v. Hochfelder*, it stated in dicta that something more than negligence is required for Section 20(a) liability.⁵³

Although the Third Circuit officially adopted culpable participation as the standard in *Rochez Bros.*,⁵⁴ some district courts in this circuit have subtly altered the application of the culpable participation doctrine. Whereas *Rochez* indicated that culpability must be evaluated as necessary

is required, it has been sufficiently alleged in this case."). See also *First Jersey Sec.*, 101 F.3d at 1472-73.

45. *In re Health Management*, 970 F. Supp. at 206.

46. See, e.g., *In re Cryomedical Servs., Inc.*, 884 F. Supp 1001, 1012 (D. Md. 1995).

47. 527 F.2d 880, 885 (3d Cir. 1975).

48. See Nancy C. Staudt, "Controlling" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts, 72 MINN. L. REV. 930, 943 (1988).

49. See S. REP. NO. 73-47, at 5 (1933).

50. See *Rochez Bros.*, 527 F.2d at 885 (citing H.R. REP. NO. 73-85, at 5 (1933); H.R. REP. NO. 73-152, at 26 (1933)).

51. See *Rochez Bros.*, 527 F.2d at 885.

52. See Staudt, *supra* note 48, at 945.

53. 425 U.S. 185, 209 n.28 (1976).

54. 527 F.2d at 885.

for a prima facie case of control,⁵⁵ recent district court decisions have required for a finding of liability evidence of culpable participation *after* control is already established.⁵⁶ In fact, it appears as though the lack of culpable participation is now used as an affirmative defense that the defendants must prove after the plaintiff presents the prima facie case of control.⁵⁷ Pragmatically speaking, it would be very difficult for a plaintiff to uncover specific instances of wrongdoing at the pleading stage of litigation. This reality has spurred “an overwhelming trend in this circuit to allow Section 20(a) actions to withstand Rule 9(b) motions based on a simple pleading of control.”⁵⁸ Courts have permitted the plaintiffs to merely allege “the circumstances [of] control”⁵⁹ in recognition that “the facts establishing culpable participation can only be expected to emerge after discovery [and] virtually all of the remaining evidence, should it exist, is usually within the defendant’s control.”⁶⁰ By permitting the plaintiff’s claim to survive a motion to dismiss on fairly vague evidence, the court has effectively mitigated the requirement that the defendant be a culpable participant in the wrongdoing to qualify as a controlling person. Admittedly, the requirement that the plaintiff plead the “circumstances of control” is more demanding than the control by status approach adopted in other circuits. Without predicating a successful prima facie case upon some proof of actual control over the primary wrongdoer, however, the court seems to reject the culpable participation doctrine for the more plaintiff-friendly potential control doctrine.

In the First Circuit, one court employed a hybrid between culpable participation and a potential control test. In *Rand v. M/A Com, Inc.*,⁶¹ the court imposed a higher burden upon plaintiffs seeking to meet the standards of a Section 20(a) claim. The court found that the directors, officers, and shareholders of a corporation may only be deemed to be controlling persons if they “dominated the activities of the corporate entity.”⁶² The

55. *Id.* at 884 (“Although Section 20(a) does not define ‘control,’ it is clear that the evidence in each case must be examined to determine to what extent the controlling person was involved in the fraudulent scheme.”).

56. *See, e.g., In re Mobilemedia*, 28 F. Supp. 2d 901, 940 (D.N.J. 1998).

57. *See id.* at 941.

58. *Derensis v. Coopers & Lybrand Chartered Accountants*, 930 F. Supp. 1003, 1013 (D.N.J. 1996).

59. *Id.*

60. *Id.*

61. 824 F. Supp. 242 (D. Mass. 1992).

62. *Id.* at 262 (citing *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105, 1122 (D.R.I. 1990)).

court in *Rand* explicitly rejected a control by status approach, instead adopting a version of culpable participation.⁶³ Specifically, the court adopted the test first stated in *Bray v. R.W. Technology, Inc.*,⁶⁴ which established that the plaintiff must “show that the defendant actually participated in, or exercised control over, the operations of the corporation in general and had the power to control the specific transaction in question. It is unnecessary to show actual participation in the alleged securities law violation.”⁶⁵ The court in *Bray* curiously added that the plaintiff must prove that certain individuals, such as directors, *actually* participated or influenced in some way the wrongful behavior of another for liability under Section 20(a) to be imposed.⁶⁶ Absent from the opinion is any explanation why plaintiffs must overcome more obstacles in cases against directors.

There are at least two effects of the culpable participation test. First, good faith changes from an affirmative defense that the defendant must prove to, in essence, an element of the prima facie case that the plaintiff must prove.⁶⁷ Before the plaintiff can even attempt to prove his case he must show that the defendant knew what the controlled person was doing, either directly or indirectly. Knowledge of the primary securities violation would necessarily vitiate any good faith or inducement defense. The affirmative defenses mentioned in Section 20(a) would seem then to be incongruous with culpable participation. Second, the participation requirement creates, in effect, a category of control with automatic liability.⁶⁸ The finding of liability collapses with the finding of control.

Because of its obvious problems, the culpable participation doctrine of control has slowly been eroded by recent cases, and rejected in some circuits altogether. For instance, the Ninth Circuit found that broker-dealers and their representatives did not have to be culpable participants to be liable.⁶⁹ Later the Ninth Circuit rejected the culpable participation doctrine for all other contexts.⁷⁰ In *Brown v. Enstar Group, Inc.*,⁷¹ the Eleventh Circuit, which had appeared to support the culpable participation

63. *Id.*

64. No. CIV.A.88-0470-Z, 1990 WL 44084 (D. Mass. Apr. 3, 1990).

65. *Id.* at *1.

66. *Id.*

67. *See* York, *supra* note 5, at 321.

68. *See id.* at 322.

69. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990).

70. *See* Arthur Children's Trust v. Keim, 994 F.2d 1390, 1398 (9th Cir. 1993).

71. 84 F.3d 393 (11th Cir. 1996).

standard in earlier dicta,⁷² instead adopted a test for control enunciated in the Eighth Circuit in *Metge v. Baehler*.⁷³

C. POTENTIAL CONTROL TEST

The Eighth and Eleventh Circuits have developed a potential control test as an alternative to the culpable participation standard. It is somewhat related to “control by status,” although it is fact-specific. Some courts have considered the power or potential power of an individual to control another person’s activities, even if that power was not actually exercised, sufficient to establish control. In fact, control may be established when the controlling person has at her disposal only the most indirect of means of disciplining or influencing the actions of the controlled person.⁷⁴ A two-part test for determining potential control was first established in *Metge*, whereby it was determined that the plaintiff had to prove first that the defendant “actually participated in (i.e., exercised control over) the operations of the corporation [person] in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised.”⁷⁵

The court in *Metge* felt that the potential control test best fit with the purpose of the 1933 Act as well as successfully “distinguish[ed] between the actual exercise of control in the violator’s principal affairs and potential control over the violation.”⁷⁶ Potential control thus enables the plaintiff to establish prima facie liability without having to establish that the alleged controlling person actually exercised control over the wrongdoer in that particular instance. Despite its similarities to the control by status doctrine, the potential control test does require that the controlling person have exercised some modicum of general control over the primary wrongdoer to satisfy the first prong of the test, and, therefore, presents a higher burden for the plaintiff than the control by status approach.⁷⁷

72. See *Rosen v. Cascade Int’l, Inc.*, 21 F.3d 1520, 1524-25 n.7 (11th Cir. 1994) (“It is well established that, for a plaintiff to make out a prima facie case that the defendant was a controlling person within the meaning of section 20(a), the plaintiff must show that the defendant . . . induced or participated in the alleged illegal activity.”).

73. 762 F.2d 621 (8th Cir. 1985).

74. See Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1010-11 (1983).

75. 762 F.2d at 631.

76. *Id.*

77. See *Turner*, *supra* note 15, at 341.

Since *Metge*, district courts in this circuit have set about to refine its application. Some courts grappled with the first part of the test that called for the defendant to have control over the general operations of the entity. It is not enough that a defendant, for example, holds the position of vice president, garners performance-based compensation, and is responsible for the sales program.⁷⁸ Rather, it seems that the defendant must occupy positions, such as Chief Executive Officer and Chief Financial Officer, which enable him to access the operations of the company as a whole.⁷⁹ Only those officers and directors who, by either direct or indirect means, controlled the content of the misleading reports or misleading statements made to the public, are accountable under Section 20(a).⁸⁰

One district court took a markedly different approach in analyzing controlling person liability. In 1993, a court in the Western District of Missouri added a new spin to *Metge*: in order for liability to attach, the defendant must “actively participate[] in the overall management” of the corporation and “actively participate[] in the fraud.”⁸¹ By inserting “active” into the equation for control, the court departed from the potential control concept, whereby the defendant need not actually have exercised control over the wrongful behavior to incur liability. The court seems to have applied the culpable participation standard, a standard expressly rejected in *Metge*. Perhaps because this case was likely wrongly decided, no subsequent case has cited to it for support.

Other circuits have followed the provisions of the *Metge* test. For instance, in *Salkind v. Wang*,⁸² a district court case originating from the First Circuit, there was sufficient evidence to determine controlling person liability “where each individual defendant was an officer or director who allegedly knew of the materially misleading statements and was in position to control or influence the content of such reports or otherwise cause corrective or accurate disclosure to have been made.”⁸³ The emphasis is

78. See *In re Digi Int'l, Inc.*, 6 F. Supp. 2d 1089, 1101 (D. Minn. 1998) (finding defendant Deaner, who possessed these characteristics, not to be a controlling person because the plaintiffs did not identify how Deaner had control over the general operations of the company outside of sales).

79. See *id.* (finding defendants Kamm, the CEO and director of Digi, and Wall, the Chief Financial Officer and Vice President of Digi, to have the requisite authority and knowledge to be liable under section 20(a)).

80. See, e.g., *Piper Jaffray Cos. v. National Union Fire Ins. Co.*, 38 F. Supp. 2d 771 (D. Minn. 1999).

81. *In re Marion Merrell Dow Inc.*, No. 92-0609-CV-W-6, 1993 WL 393810, at *12 (W.D. Mo. Oct. 19, 1993).

82. No. CIV.A.93-10912-WGY, 1995 WL 170122, at *1 (D. Mass. 1995).

83. *Id.* at *7.

not on whether the defendant *actually* influenced the wrongful behavior but rather whether the defendant could have forced the wrongdoer to obey the law. This approach requires a fact specific inquiry into the individual defendant's actual power within the corporation.

In fact, one court in the Third Circuit, which should apply the culpable participation doctrine as articulated in *Rochez Bros.*, appears to use the potential control approach when the opinion states that control requires that a person possess "actual power or influence over the allegedly controlled person."⁸⁴ "[H]eavy consideration [is given] to the *potential* power of a person to influence and control the activities of another, as opposed to actual exercise of such power," although "some culpability on the part of the defendant is necessary."⁸⁵

The Fifth Circuit appears, at least in some of its decisions, to also employ the potential control test, despite the fact that many courts in this circuit have used the culpable participation test.⁸⁶ This Circuit is in such a state of confusion that in 1993 the Fifth Circuit actually acknowledged the confusing results some of its opinions have engendered. For instance, *Dennis v. General Imaging, Inc.*⁸⁷ led many district courts to use the culpable participation doctrine despite the fact that *Thompson* had never been overruled. So confusing was the *Dennis* decision that in *Abbott v. Equity Group, Inc.*,⁸⁸ buried in a footnote, the court conceded that "*Dennis* does not accurately reflect our rejection in *Thompson* of a 'culpable participation' requirement."⁸⁹ The court in that opinion demurred from deciding, however, if the plaintiffs needed to demonstrate that the defendants actually exercised their power to control the general operations of the company, or merely that they had the power to do so, because neither argument could have possibly applied to the defendants in *Abbott*.⁹⁰

The Sixth Circuit, in *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*,⁹¹ cited the Eighth Circuit's *Metge* test with approval.⁹² The

84. *See In re Mobilemedia*, 28 F. Supp. 2d 901, 941 (D.N.J. 1998) (quoting *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 548 (9th Cir. 1986)).

85. *In re Chambers Development*, 848 F. Supp. 602, 618 (W.D. Penn. 1994) (emphasis in original) (citation omitted).

86. *See supra* Part II.B.

87. 918 F.2d 496 (5th Cir. 1990).

88. 2 F.3d 613 (5th Cir. 1993).

89. *Id.* at 620 n.18.

90. *See id.* at 620.

91. 973 F.2d 474 (6th Cir. 1992).

92. *See id.* at 486.

test in *Metge* “sets forth the most lenient standard among the Circuits.”⁹³ One can best gauge the application of the *Metge* test when an outside director is accused of being a controlling person. In *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.*,⁹⁴ the district court held that the plaintiffs must show that the outside directors had some modicum of actual control or influence over the corporation. Signing “group published” information will not suffice to attach liability to the outside director.⁹⁵

The most recent case in the Sixth Circuit dealing with controlling person liability is *City of Painesville, Ohio v. First Montauk Financial Corp.*⁹⁶ The findings of the court were quite similar to those before it. Here the court interpreted control to mean both indirect and direct action or influence. The means of control include “other business relationships, interlocking directors, family relationships and a myriad of other factors.”⁹⁷ The court adopted the potential control test as enunciated in *Metge* and it draws support for its decision from other courts’ decisions.⁹⁸

The Seventh Circuit’s test is similar to that presented in *Metge*. First, the defendant must have “actually exercised general control over the operations of the entity.”⁹⁹ Second, the defendant must possess the “power or ability to control the specific acts constituting the primary violation.”¹⁰⁰ This standard was first adopted in the 1992 Seventh Circuit case *Harrison v. Dean Witter Reynolds, Inc.*¹⁰¹

“Control” is defined more broadly in the Seventh Circuit than in other circuits, including both actual direction of the primary wrongdoer but also “the exercise of a sufficient degree of indirect discipline or influence over that person.”¹⁰² The court, therefore, takes a more pragmatic approach in drawing the boundaries of control. Control by virtue of position in the company can only be inferred if there is real responsibility attached to the position. In essence, controlling persons must have within their purview

93. *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1134 (W.D. Mich. 1996).

94. *Id.*

95. *See id.* at 1134-35.

96. 178 F.R.D. 180 (N.D. Ohio 1998).

97. *Id.* at 192.

98. *See id.* at 192 (“[C]ourts have focused on the ‘power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.’”).

99. *In re Discovery Zone*, 943 F. Supp. 924, 943 (N.D. Ill. 1996).

100. *Id.*

101. 974 F.2d 873 (7th Cir. 1992).

102. *In re Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1473 (N.D. Ill. 1996) (citing *Harrison v. Dean Witter Reynolds, Inc.* 79 F.3d 609, 614 (7th Cir. 1996)).

the “practical ability to direct the actions of the people who issue or sell the securities.”¹⁰³ In *Donohoe v. Consolidated Operating & Production Corp.*¹⁰⁴ the Seventh Circuit refined what it meant by “practical.” The ability to control hinges not on the “qualifications” of the alleged controlling people but rather refers to their “authority to control.”¹⁰⁵ The court subtly rejected the culpable participation doctrine in *Donohoe* by noting that if the rule were different than the two prong test that they forwarded, “corporate officers and directors could escape controlling liability by remaining as ignorant as possible—surely not the result that Congress intended.”¹⁰⁶

In the last decade, the Ninth Circuit has moved away from strict adherence to the culpable participation standard and towards a potential control test. For an argument to be successful in this circuit, the manner in which the alleged “controlling person” controls the primary violator must be asserted. The plaintiff need not demonstrate that the defendant possessed day-to-day control of the corporation.¹⁰⁷ However, in *Kaplan v. Rose*,¹⁰⁸ the defendant’s participation in the day-to day affairs of a small corporation, in conjunction with his status as an officer and director, indicated sufficient “control” to survive summary judgment.¹⁰⁹ What exactly the plaintiff must show lies somewhere in between the rejected control by status approach and domination of the corporation. One court determined that the plaintiff’s assertion that the defendant was a controlling person by reason of his position as director and officer and his “substantial” stock ownership in the company was sufficient to overcome a motion to dismiss.¹¹⁰

In the 1990 case of *Hollinger v. Titan Capital Corp.*,¹¹¹ the Ninth Circuit held that a plaintiff was not required to show “culpable participation” in order to attach liability to an individual broker-dealer.¹¹² Since *Hollinger*, the courts have slowly chipped away at the doctrine of

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

104. *Id.*

105. *Id.*

106. *Id.*

107. *See In re Silicon Graphics, Inc.*, No. C 96-0393, 1996 WL 664639, at *14 (N.D. Cal. Sept. 25, 1996). *See also In re Silicon Graphics, Inc.*, 970 F. Supp. 746, 763 (N.D. Cal. 1997); *Powers v. Eichen*, 977 F. Supp. 1031, 1044 (S.D. Cal. 1997).

108. 49 F.3d 1363 (9th Cir. 1994).

109. *See id.* at 1382.

110. *See Powers*, 977 F. Supp. at 1045, n.9.

111. 914 F.2d 1564, 1575 (9th Cir. 1990).

112. *Id.* at 1575.

culpable participation. In fact, the Ninth Circuit stated in *Paracor Finance, Inc. v. General Electric Capital Corp.*¹¹³ that the plaintiff need not prove the alleged controlling person knew of or “culpably participated” in the primary violation.¹¹⁴ However, plaintiffs must still allege “actual power or influence” over the corporation to be successful.¹¹⁵ The controlling person then has the burden of proving that his actions were in good faith and did not directly or indirectly influence the acts that compose the primary wrongdoing. By ejecting the scienter requirement from the definition of “controlling person” the Ninth Circuit has moved unabashedly towards the potential control test.

The Eleventh Circuit was first confronted with the difficulty of selecting the appropriate standard for controlling person liability in 1996.¹¹⁶ It essentially combined two cases—*Pharo v. Smith*¹¹⁷ and *G.A. Thompson & Co. v. Partridge*¹¹⁸—to provide justification for the adoption of the potential control test. In *Pharo*, the court held that a defendant could not be liable under Section 20(a) if he did not have the power to control the management of the company or the company itself.¹¹⁹ In *G.A. Thompson & Co.*, the defendant was determined to have control because he possessed “the requisite power to directly or indirectly control or influence corporate policy.”¹²⁰ Thus, a person is said to have control if that person “had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws. . .and had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.”¹²¹ This test appears substantively identical to that of the Eighth Circuit. The court in *Brown*, however, specifically refused to decide whether “power to control” translated into the actual exercise of that power or an abstract power.¹²² It remains to be seen if the potential control test set forth in the Eighth Circuit, which requires

113. 96 F.3d 1151 (9th Cir. 1996).

114. *See id.* at 1161.

115. *Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1355 (S.D. Cal. 1998).

116. The Fifth Circuit split into the Fifth and Eleventh Circuits in 1981. The Eleventh Circuit adopted all decisions of the former Fifth Circuit prior to October 1, 1981 as binding precedent in *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981).

117. 621 F.2d 656 (5th Cir. 1980).

118. 636 F.2d 945 (5th Cir. 1981).

119. 621 F.2d at 670-71.

120. 636 F.2d at 958.

121. *Brown v. Enstar Group, Inc.* 84 F.3d 393, 396 (11th Cir. 1996) (quoting *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)).

122. *See* 84 F.3d at 396 n.6.

actual control, will differ from the Eleventh Circuit's interpretation of control.¹²³

IV. DISCUSSION

The discussion above clearly demonstrates the chaos that currently exists among courts. Out of the cacophony of decisions presented above it becomes clear that the law regarding "control" is in a state of fluctuating evolution. Those courts that have staked out a particular test to determine who is a controlling person have been less than faithful to their decisions. The Second, Third, Fourth, and Ninth Circuits, for example, have softened their stances on culpable participation and moved toward potential control. This case study proves that courts must choose a standard or definition for controlling person liability. Both individual defendants and society as a whole suffer from so much uncertainty in the law. But where do we turn to find a universal standard that will finally bring uniformity to an area notoriously in discord?

The purposes of the Securities and Exchange Acts can serve to illuminate the ideal framework for control. Both Acts were the brainchildren of President Roosevelt and other supporters of the New Deal. The Great Depression indicated to many that corporations needed a stronger regulatory system that was independent of the market itself. Self-regulation simply did not prevent the rampant abuse prevalent in the late 1920s. The government stepped in to convince the public to put their trust and their money back into Wall Street. Securities regulation was used, and indeed still is used, to maintain that trust between corporations and the public. By setting up a framework for disclosure and accountability, the government sought to make investing seem less risky. This concept was used in areas outside of securities and has achieved similar results. For instance, the Federal Deposit Insurance Corporation was established as a watchdog over the banking system so that the public could trust savings and loans again.

Fundamentally, controlling person liability is meant to assuage the public psyche. Even though investors might not be able to prove that a defendant officer of the company was directly involved in a scheme to defraud shareholders, they may be able to prove that officer should have been able to stop the wrongdoing. Controlling person liability puts a

123. For a comparison of the test enumerated in *Brown* with that in *Metge*, see Turner, *supra* note 15.

human face on the wrongs of the corporation and meets the investor's psychological need for accountability. It does not matter if controlling person liability actually deters or alters the defendant officers' or directors' behavior. Controlling person liability serves the investor's need to make sure that *someone* is accountable and *can* be made to pay.

A. CULPABLE PARTICIPATION:
AN INADEQUATE STANDARD OF CONTROL

In light of the goal of controlling person liability, it becomes apparent that culpable participation is the least effective of the three standards. The test is so burdensome upon the plaintiff that she rarely succeeds in her controlling person claim. Perhaps that is why so many courts, as we have seen above, have drifted away from the doctrine. Many courts have explicitly cited the lopsided access to information for their adoption of the control by status test for summary judgment motions. Even in the Third Circuit, where culpable participation is ostensibly the standard used, the courts have recognized that "the facts establishing culpable participation can only be expected to emerge after discovery and virtually all of the remaining evidence, should it exist, is usually within the defendants' control."¹²⁴ Thus, requiring that culpable participation be presented for a prima facie case of control to be successful is tantamount to denying all controlling person claims. There is absolutely no incentive within the corporation to disclose the wrongdoing, much less the fact that officers or directors knew about it. Moreover, culpable participation fails to distinguish between the separate issues of liability and control.

Perhaps as a result, circuits that originally advocated culpable participation seem to be softening their stance. For instance, the Third and Fourth Circuits have removed the scienter requirement for the prima facie case of control, but added it as a requirement to attach liability. This is an important distinction for two reasons. First, the plaintiff has to prove much less for purposes of summary judgment. Second, reshaping the culpable participation requirement is the first step towards fully incorporating it into the affirmative defense. Culpable participation would be the inverse of the good faith affirmative defense if it were not for the fact that, currently, the plaintiff bears the burden of proof for the former, the defendant the latter. There are already signs that courts are collapsing this difference, however,

124. *Derensis v. Coopers & Lybrand Chartered Accountants*, 930 F. Supp. 1003, 1013 (D.N.J. 1996) (quoting *Easton & Co. v. Mutual Benefit Life Ins. Co.*, Fed. Sec. L. Rep. (CCH) ¶ 96, 595, ¶ 92, 808 (D.N.J. 1992)).

and holding that one is the inverse of the other. For instance, a 1997 case in the Eastern District of New York stated that the lack of knowledge and culpability “constitute an affirmative defense.”¹²⁵ In practical terms, this district court has greatly limited the applicability of culpable participation. It does not eliminate it altogether, because ignorance of the primary wrongdoing could, in this framework, negate liability whereas otherwise a defendant may have to show something more than ignorance to be able to employ the “good faith” exception.

It makes sense that the courts have almost unanimously drifted away from the culpable participation doctrine. Perhaps the shift away from the doctrine reflects a tacit acknowledgement by judges that culpable participation is inconsistent with the purpose of the Securities and Exchange Acts. Many commentators have long criticized the doctrine as “failing to distinguish control from liability.”¹²⁶ If the defendant officer knew of and participated in the wrongdoing, then he could be charged individually for the primary securities violation. There would be no need for the statute whatsoever because it would not aid in finding additional persons accountable. Instead, the Securities and Exchange Acts should be interpreted as adding a new basis for liability for those individuals who previously escaped liability, but who were nonetheless somehow derelict in their duty to supervise the company. Controlling person liability is additional to the primary violation and should be treated as such. Furthermore, there is no hint from the text of either Sections 20(a) of 1934 Act and 15 of the 1933 Act that there is any knowledge requirement whatsoever for liability. Culpable participation is inconsistent with the plain meaning of the statutes and simply deviates too far from the statute’s aims to continue to be viable. However, this still leaves us with the question of what should be the standard for control.

B. CONTROL BY STATUS: AN UNJUST REMEDY

Control by status is a logical extension from the wording of the statutes themselves. Control by status definitely provides comfort to the injured stockholder, for it is by far the most sweeping in attaching liability. However, control by status is so lenient such that it begins to resemble insurance. There is no investigation whatsoever into whether the defendant could have prevented or known about the primary violation. It is for this

125. *In re Health Management*, 970 F. Supp. 192, 206 (E.D.N.Y. 1997).

126. York, *supra* note 5, at 319.

reason that the standard is decried as being unfair. It also can lead to more lawsuits against more managers, which is undesirable both to those who assume positions of authority within the company and to society at large. However, it should be noted that control by status only increases the scope of the litigation—the plaintiff will list both individuals and the corporation on his complaint—but it does not spur entirely new cases, since controlling person liability is a secondary violation.

Control by status is extremely problematic. By assigning liability to those who hold a specific title regardless of whether they actually possessed any ability to deter or monitor the act that led to the primary violation, the court creates two problems. First, individuals savvy to this reality might alter their positions so that they cannot be found liable and in their stead place a judgment-proof individual as a figurehead. More importantly, vicarious liability, such as control by status, is ineffective at deterring wrongful behavior. For instance, Professors Arlen and Carney found that fraud on the market was usually discovered within the relatively short period of 16.3 months after it was committed, buttressing their hypothesis that individuals commit fraud as a last resort.¹²⁷ Typically the manager engaged in the fraudulent behavior sought to conceal news that the company was ailing in order to save his or her job.¹²⁸ Thus, to hold that person or that person's superior responsible would in no way deter the wrongdoing—the manager felt as though he had no other option. Control by status should be sufficient for purposes of summary judgment, but something more is needed to attach liability.

C. THE POTENTIAL CONTROL TEST: AN UNEASY CONSENSUS

Potential control can aptly be viewed as a *via media* between control by status and culpable participation. Only those who could have prevented the wrongdoing would be accountable under potential control. This standard also acknowledges the reality that very few plaintiffs are able to uncover enough information linking the defendant to the deed to prevail in secondary liability. As the discussion in Part III demonstrates, potential control is already the most prevalent approach in the courts—the First, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, and Eleventh Circuits all, to varying degrees, have moved towards this test. The others seem to be inching toward this approach in recent decisions. To summarize, the

127. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 726-27 (1992).

128. See *id.* at 726.

potential control test requires that, to control, a person must have possessed the power to control the general affairs of the primary violator and must have had the power to control or influence, either directly or indirectly, the specific policy that resulted in the wrongdoing.

Although potential control is preferable to either of the other standards, it is also rife with problems. The test is divided into two prongs. However, the exact standards required to prove either prong—the “power to control” either the general affairs or the specific policy—are left unclear. Because the determination of control is fact intensive, this standard provides little guidance to litigants. The fact-specific inquiry into power leads to inconsistent holdings from court to court. Patterns for liability cannot be discerned even within circuits that uniformly apply a version of the test. The greatest criticism that can be leveled upon this test is that it could punish the innocent for the wrongs of another. It is certainly possible that potential control will succeed in holding people accountable who negligently or willfully failed to perform their supervisory role in the corporation. As with the control by status approach, however, this test does permit stockholders to feel as though someone is accountable for the wrongs of the corporation. Although this might lead to more litigation, it does require that the plaintiff prove some connection between the primary violation and the defendant. As noted earlier, the amount of additional litigation is minimized because all secondary liability cases are decided in conjunction with the primary violation. Society does not bear the same amount of cost in terms of court time as it would if this action could be brought separately from another securities violation.

Moreover, the courts are still divided about whether the power to control the general affairs of the corporation must be actual or merely possible. Both the Tenth and Eleventh Circuits have not decided whether abstract power will suffice for liability purposes. The proper point of inquiry should be whether the individual possessed the power to control the general affairs of the corporation, not whether she actually exercised that power.

There are several reasons why potential control is preferable to an actual control requirement. First, abstract control will prevent some individuals, specifically directors, from engaging in willful ignorance about the company as a whole. If directors, particularly outside directors who would not be involved in the day to day management anyway, were only held liable once they actually exercised their power to make a policy change within the company, the company could be negatively affected.

Not only would the director not want to be exposed to information about a possible securities violation, he may choose not to change company policy on important matters because merely doing so would subject him to secondary liability. It is certainly not in the stockholders' best interests for directors and executive officers to have such a disincentive for improving the company.

Second, although utilizing the potential control wording would seem to increase vastly the kinds of people held liable, it does not lower the net of liability over individuals who should not be held liable. One critique of the first prong requirement of the potential control test, which requires only abstract control, is that it "is the functional equivalent of the control by status approach."¹²⁹ There is merit to this contention. Without some sort of actual control it would seem that the only qualification necessary to satisfy the first prong of the test would be a position in the corporation that gives that person access to the general affairs of the corporation. Potential control is different from control by status, however, in that it looks into the particular circumstances of control. If the defendant director did not exercise control over the corporation's affairs because to do so was not within his "job description," for example, then the director would not control the general affairs of the corporation. If, on the other hand, it is normally within the purview of directors within the corporation to participate in the general affairs of the corporation and the director for some reason does not do so, she will meet the first part of the test with respect to control.

The circuit split over utilizing actual and potential control in the first prong of the test undermines its usefulness as a uniform standard. In addition, the potential control approach's emphasis on specificity renders it of little use in the quest for consistency. Even within the circuits, such as the Eighth Circuit, which mandate actual control for the first part of the test, the factual analysis into what qualifies as "actual" control is so case-specific that it provides no guidance whatsoever. Despite the fact that the potential control test is better than the current alternatives, it is far from the ideal standard for defining control.

D. A NEW PATH

The three current standards fail in their attempt to define control in light of the purposes of the Exchange and Securities Acts. A new approach

129. Turner, *supra* note 15, at 351.

is needed, one that provides stronger guidelines. Any “standard,” whether culpable participation or potential control, will, as we have seen, lead to confusing outcomes that utterly fail to provide guidance to potential litigants. Although Congress did not specify a definition for control, other organizations have attached meaning to the term. The New York Stock Exchange, a self-regulatory organization that also reports to the Securities and Exchange Commission, has implemented Rule 2 in an effort to delineate who qualifies as a controlling person.¹³⁰ Rule 2 defines “control” as meaning “the power to direct or cause the direction of the management or policies of a person whether through ownership of securities, by contract, or otherwise.”¹³¹ The New York Stock Exchange rule places the burden on the individual to prove that he does not control another person if that person “(1) has the right to vote 25% or more of the voting securities, (2) is entitled to receive 25% or more of the net profits; (3) or is a director, general partner or principal executive officer (or person occupying a similar status or performing similar functions). . . .”¹³² The courts should adopt a framework similar to this for the first part of a new two-part test.

Rule 2 sets the bar for control through ownership of stock relatively high—a person has to own at least a quarter of the company, or expect to receive at least a quarter of the company’s profits. Individuals or organizations that own that great of a stake in one single firm, so the argument goes, most likely have an active interest in the operations of the company. Because of her large investment, the individual would or could have significant influence over the company’s operations. The remaining prong of the control definition includes directors, general partners, or principal executive officers. This provides a rough laundry list of the types of people who will be held accountable under Rule 2, which, although less specific than ideal for those trying to anticipate liability, is certainly preferable to other definitions, such as the SEC definition, which offers very little guidance as to what constitutes “possession . . . of the power to direct or cause the direction of management and policies of a person.”¹³³

As any first year law student will acknowledge there are many advantages to a bright line rule. Bright line rules can be more efficient to

130. The NYSE does not have an equivalent section 15 or Section 20(a) violation. Rather, Rule 2 is used to define a controlling person for purposes of such Rules as NYSE Rule 312(g), which prohibits any NYSE member with a publicly held security outstanding from recommending a security issued by a corporation that is controlled by, under common control with, or that controls the NYSE member.

131. Notices, SEC 54 FR 10605, n.6 (1989).

132. *Id.*

133. 17 C.F.R. § 230.405 (1999).

all parties involved because it is clear who falls under the rule and who does not. Therefore, a plaintiff is unlikely to bring a suit for controlling person liability unless the possible defendant actually qualifies. Directors and officers, or other individuals who also fit under the definition of control, are aware that they can be held individually liable for securities fraud. This could, in turn, cause those persons to be more diligent in their administration of the company. These individuals would know exactly what obligations they must fulfill to the shareholder. This would be particularly valuable to outside directors, who typically do not actively manage the day-to-day operations of the firm, but may nonetheless be liable under Sections 15 and 20(a).

This approach undoubtedly has its drawbacks. First and foremost, Congress deliberately declined to define “control” because it felt the purpose of the Acts could be better served by allowing the courts to apply them in a flexible manner. The courts have indeed been “flexible” in their interpretation of control, but this has come at the expense of clarity in the law. The courts have had sixty years to come to a consensus about who controls a company for purposes of these regulations, yet a survey of recent cases nationwide has uncovered tremendous discord. Second, Rule 2, like all definitions, is vague. For instance, any “person occupying a similar status or performing similar functions”¹³⁴ as an executive officer or general partner presents the problem of determining what functions such a person typically performs. Some would contend that defining what an executive officer does is as difficult as determining control. This, however, is simply not the case. A court, for example, could look at the general duties of officers within the same industry as the defendant’s company and judge whether the defendant’s duties are similar to the typical duties of someone clearly presumed to control from the definition. The “similar functions” clause allows for some judicial discretion, which is absolutely essential to ensure the just application of the test and to be true to congressional intent. There may be situations in which an individual without the requisite title actually controls the company. This part of the definition will specifically hold these people liable.

The second part of this new test co-opts the only significantly useful element of the culpable participation standard—the part that sought to ensure that there is some sort of link between the controlling person and the controlled. Otherwise, the test would be too similar to the control by status approach, which, as demonstrated in Part III, is already overwhelmingly

134. Notices, SEC 54 FR 10605, n.6 (1989).

rejected by the courts. This element of the test is taken from the two-prong potential control test. It states that the defendant must have the power to influence, directly or indirectly, the specific policy or entity that inspired the primary violation. The second prong of the test effectively narrows the field of potentially liable individuals. For a plaintiff to prevail, she must show: (1) that the defendant was a controlling person as defined in Rule 2; and (2) that he had the capacity to direct or influence the specific policy or the specific individual from whom the primary violation originated. The presumption behind this theory is that the defendant could have known and/or attempted to stop the violation from occurring if he had exercised his influence. This test undoubtedly places a higher burden on plaintiffs, albeit not an unfair one. It acknowledges the reality that the defendants possess most of the information. It further acknowledges that the defendants are in a better position to clear themselves of wrongdoing by presenting a good faith defense and that a plaintiff would be unlikely to uncover the evidence of actual participation in the wrongdoing from within the entity.

Finally, the SEC definition of control buttresses the adoption of the test enunciated above. Control according to the SEC means the “*possession, direct or indirect, of the power to direct or cause the direction of the management and policies*”¹³⁵ of the controlled person. To possess power means that one has the ability to use one’s power, but it by no means mandates the exercise of that power. By its word choice the SEC stresses what it sees as the core of the concept of control—the capacity to exercise power. Power or control is not necessarily predicated upon action.

The SEC definition of control, therefore, suggests the supremacy of the control by status and potential control standards. The new test outlined in this Note has, however, incorporated the best elements of all the approaches currently used in courts throughout the nation. It gives guidance to the courts and to litigants as to which individuals in a company are presumed to control while at the same time allowing some judicial discretion in those instances when an individual does not neatly fit into a category. It also makes sure that the defendant must have a significant link to the area from which the primary wrongdoing stemmed, thereby limiting liability to those who might have been able to make a difference. Moreover, this test provides comfort to investors because, if they can meet the requirements, they know they can prevail in holding the management of a company responsible for any mismanagement that may occur.

135. 17 C.F.R. § 230.405 (1999) (emphasis added).

V. CONCLUSION

From their inceptions, Section 15 of the 1933 Act and Section 20(a) of the 1934 Act have spawned prolific debate. This Note has shown that to determine exactly where “the buck stops” is still extremely difficult. The three approaches developed to identify the controlling person have utterly failed to aid litigants or judges in determining who controls. The state of law today is as murky as it was twenty years ago.

By examining holdings of each circuit throughout the 1990s, the dire state of controlling person law becomes clear. Those courts that are purportedly adherents to the culpable participation doctrine have eased their stance by moving the scienter requirement out of the prima facie case. This trend may have developed in response to the recognition that it is virtually impossible for the plaintiff to prevail if he must prove culpable participation. Most courts have now adopted a version of the potential control test. That test, however, has been so unevenly applied that little about the characteristics of controlling persons are revealed. Courts in all circuits have failed to apply the standard they have enunciated.

All three tests are inadequate. This Note has suggested a new test, one which incorporates a definition modeled after NYSE’s Rule 2. Rule 2 provides the clarity that history has proven that courts need while still allowing for some discretion. This new test goes further in its second section by requiring that the defendant must have the power to control the specific area of the corporation or specific policy from whence the primary violation occurred. This test will help insure that those found liable under the controlling person statutes actually were involved with or could have prevented the primary wrongdoing. Although the test somewhat limits the number of defendants available to a wronged shareholder, it still enables the stockholder to feel that someone is accountable when the corporation violates securities laws. Investors gain no sense of general security when the responsibility for securities violations can be shirked from one shadowy figure to the next. The buck must stop somewhere, and it is the responsibility of the courts to firmly delineate and define the controlling persons who, in the end, are left holding the “buck.”