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MULTIPLE DEFENDANTS IN SECURITIES LAW FRAUD CASES: AIDING AND ABETTING, CONSPIRACY, *IN PARI DELICTO*, INDEMNIFICATION, AND CONTRIBUTION

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This Article bears a date of November 20, 1971. Much of the research and
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INTRODUCTION

The explosive growth of securities law fraud litigation during the last decade under federal statutes and rules¹ is now well recognized. As learning has advanced, plaintiffs' lawyers have become more aware of the many possible avenues for recovery. Federal law has not only provided a fertile source of substantive theory, but through the Federal

¹ *E.g.*, Securities Act of 1933 §§ 11-12, 15 U.S.C. §§ 77k-l (1970) [hereinafter cited as the 1933 Act]; SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1971); SEC Reg. 14A, 17 C.F.R. §§ 240.14a-1 to -103 (1971) (proxy rules) (promulgated under Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n (1970) [hereinafter cited as the 1934 Act]); Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968).

Although rule 10b-5, the primary regulation upon which most securities law private suits rest, was promulgated in 1942, SEC Securities Exchange Act Release No. 3230 (May 21, 1942), only during the last decade has extensive private litigation utilizing the rule been prevalent. (Only 54 cases were decided under rule 10b-5 during the period 1946-1962. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 687-90 (1963). Since that time the volume of litigation has grown to well over 100 reported cases each year.) The best known application of the rule has been in cases involving misrepresentations and nondisclosures in connection with purchases and sales of securities. *E.g.*, SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part, rev'd in part & remanded*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *on remand*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd in part, rev'd in part & remanded*, 446 F.2d 1301 (2d Cir. 1971). It has also been used to challenge corporate action in mergers, liquidations, sales of control, corporate purchases or sales of securities, and similar transactions. Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); Ruder, *Challenging Corporate Action Under Rule 10b-5*, 25 BUS. LAW. 75 (1969). Similarly, the federal proxy rules have been used to attack activities in the corporate takeover setting, *e.g.*, Mills v. Electric Auto-Lite Co., 281 F. Supp. 826 (N.D. Ill. 1967), *rev'd in part & remanded*, 403 F.2d 429 (7th Cir. 1968), *vacated & remanded*, 396 U.S. 375 (1970), as has § 14(e) of the 1934 Act, *e.g.*, Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969). Broker-dealer duties to their customers have been enforced under rule 10b-5, *e.g.*, Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970), *modifying & aff'g* 283 F. Supp. 417 (N.D. Cal. 1968), and customers have also felt the rule's bite, *e.g.*, A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967). Most cases involving attacks on multiple defendants have included demands for extremely large amounts as damages. The analysis in this Article will assume the existence of such demands in derivative or class actions based upon complicated factual circumstances.

Rules of Civil Procedure, particularly rules dealing with class actions² and derivative suits,³ has offered procedural advantages for plaintiffs.

As securities law litigation has grown, imaginative plaintiffs have included greater numbers of persons and corporations as defendants. With increasing frequency, securities fraud complaints are naming as defendants not only primary wrongdoers, but many whose activities are collateral or secondary to the primary wrong. For instance, in *Carpenter v. Hall*,⁴ a case alleging misrepresentations and market manipulations by Westec Corporation insiders, the plaintiff named ninety-three persons, partnerships, and corporations as defendants. The complaint alleges that the primary defendants, E. M. Hall, Jr., and James W. Williams, should share liability with other defendants who "aided and abetted" or "conspired with" the primary defendants. These "secondary defendants" include associates of Hall and Williams, an accounting firm, brokerage firms, banks and other lenders, individuals who purchased stock and arranged loans, and officers and employees of many of the corporate and partnership defendants.⁵ In multiple defendant cases like the Westec litigation, the participation, degree of knowledge, and agreement by the various defendants in the wrongdoing will be extremely varied. So too, the nature of the duties owed to the public will vary. Some of the defendants, such as corporate officers, will owe fiduciary obligations to plaintiff shareholders. Others, such as accountants and brokers, will owe obligations stemming from their

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² FED. R. CIV. P. 23.

³ *Id.* 23.1.

⁴ 311 F. Supp. 1099 (S.D. Tex. 1970).

⁵ Complaint at 2-3, *Carpenter v. Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970).

The Westec litigation promises to continue for several years. The principal case has already survived a motion to dismiss, at least temporarily, *see* Ernst & Ernst v. United States Dist. Court, 439 F.2d 1288 (5th Cir. 1971). In addition, there has been a rash of actions by parties connected with the Westec bankruptcy. *In re* Westec Corp., 434 F.2d 195 (5th Cir. 1970) (defendant versus bankruptcy trustee for performance of a contract); E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969) (disqualification of counsel in a suit by brokerage firm against one of its officers); H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶92,300 (S.D.N.Y. 1968), *aff'd*, 414 F.2d 93 (2d Cir. 1969) (shareholder versus brokerage firm to determine status of a straddle option when trading in Westec stock was suspended); Wyndham Associates v. Bintliff, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶92,016 (S.D.N.Y. 1967), *aff'd*, 398 F.2d 614 (2d Cir.), *cert. denied*, 393 U.S. 977 (1968) (removal to Texas of suit by Westec shareholders suing insiders); Goodkind v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 44 F.R.D. 464 (S.D.N.Y. 1967) (motion to require production of documents); Cosmos Bank v. Bintliff, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶91,969 (S.D.N.Y. 1967) (debtor bank versus owners of Westec stock placed as collateral); Schneider v. Sears, 265 F. Supp. 257 (S.D.N.Y. 1967) (removal to Texas of suit by Westec shareholders suing insiders). Several criminal cases have also been produced, including United States v. Williams, 424 F.2d 344 (5th Cir. 1970); United States v. Lilley, 291 F. Supp. 989 (S.D. Tex. 1968).

The author of this Article has acted as consultant to a law firm representing a lender who has been named as a defendant in *Carpenter v. Hall*, but who also qualified as part of the class of plaintiffs on whose behalf the suit has been brought.

professional status. Under such circumstances, the problems faced by courts in attempting to reach just results for all parties are immensely complicated.

This Article is directed primarily toward discussion of liability for aiding and abetting and for conspiracy. However, since courts tend to confuse doctrine when dealing with these theories of so-called "secondary liability," it is also important to understand other theories that may be used to impose liability upon defendants who are not the primary wrongdoers.

At the outset one distinction should be emphasized. In most multiple defendant securities law suits some of the defendants will be primarily engaged in the wrongdoing, while others will be engaged only in a secondary fashion. This distinction between primary and secondary wrongdoers provides a method for determining liability and for allocating rights among wrongdoers. For purposes of this Article, persons owing direct duties to the public will be classified as primary wrongdoers. Those whose liabilities arise only because another has violated the law will be called secondary wrongdoers. In most cases those who are only secondarily liable will be less culpable than those who are primarily liable.

After contrasting the doctrines of conspiracy and aiding and abetting with other liability theories, this Article will examine the theories of contribution, indemnification, and *in pari delicto* as tools for determining relative rights and liabilities in multiple defendant cases. In general, the following conclusions will be reached:

(1) In most cases liability under the securities laws will be imposed because the defendant has been a participant in the primary wrongdoing or has violated an independent duty.

(2) Liability may also be imposed through use of controlling persons sections of the Securities Acts or through use of agency doctrine.

(3) Imposition of liability upon defendants utilizing an aiding and abetting theory requires proof that the secondary defendant knew of the illegal act and rendered positive assistance to the wrongdoers, whereas imposition of liability under a conspiracy theory requires proof that the defendant knowingly entered into an agreement the purpose of which was the consummation of an illegal act.

(4) The defense of *in pari delicto* will probably be available only where the party against whom the defense is asserted is as culpable or more culpable than the party asserting the defense.

(5) Indemnification is likely to be awarded only where differences in fault are clear.

(6) Contribution between defendants is the most likely means of limiting excessive liability for multiple defendants.

I. AVAILABLE THEORIES OF LIABILITY

In adopting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress recognized that persons other than the primary participants in a securities transaction might incur liability. Both the 1933 Act and the 1934 Act contain so-called controlling persons sections, which are available to impose securities law liability upon persons who did not participate directly in the illegal course of conduct.⁶

Neither the courts nor the SEC have been content to rest secondary liability upon the controlling persons sections, but have instead turned to agency theory, to principles of misrepresentation and deceit, to tippee liability theory, and finally to aiding and abetting and conspiracy doctrines. Proper understanding of the role played by the latter two doctrines requires that attention also be paid to the other doctrines.

A. *Agency Theory Contrasted With the Controlling Persons Sections*

The most obvious approach to secondary liability under the federal securities laws lies in the controlling persons sections of the 1933 and 1934 Acts. The 1933 Act provides that anyone controlling a person liable under section 11 or section 12 shall also be liable "unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."⁷ The 1934 Act creates similar liability but contains a slightly different defense. It provides that the controlling person will be liable "unless the controlling person acted in good faith."⁸ It also contains a requirement that the person

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⁶ 1933 Act § 15, 15 U.S.C. § 77o (1970) ; 1934 Act § 20, *id.* § 78t.

⁷ The 1933 Act provides the following in § 15:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [sections 11 or 12], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1970).

⁸ The 1934 Act contains the following provisions in § 20:

(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

"did not directly or indirectly induce the act or acts constituting the violation."⁹ Both sections place the burden of proof on the defendant.¹⁰

The apparent purpose of the controlling persons provisions is to cope with attempts to avoid liability by causing others to engage in the unlawful activity. One of the House reports dealing with section 15 of the 1933 Act states that the so-called "dummy provisions" were "calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other."¹¹

The term control is not specifically defined, allowing the possibility of broad definition. According to the drafters of the 1934 Act, the failure to define control was deliberate:

It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.¹²

The broad approach taken toward the definition might suggest that the number of persons falling into the "control" category would be rather large. The use of sections 15 and 20 has been limited, however, because of the special defenses contained in the sections.

Two cases, *Kamen & Co. v. Paul H. Aschkar & Co.*¹³ and *Johns Hopkins University v. Hutton*,¹⁴ illustrate the applicability of the special defenses and the desire of plaintiffs to avoid them. Both cases contain contentions that the controlling persons sections are not the exclusive

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.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

15 U.S.C. § 78t (1970).

⁹ *Id.*

¹⁰ 1933 Act § 15, 15 U.S.C. § 77o (1970); 1934 Act § 20(a), 15 U.S.C. § 78t(a) (1970).

¹¹ H.R. REP. NO. 152, 73d Cong., 1st Sess. 27 (1933).

¹² H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934).

¹³ 382 F.2d 689 (9th Cir. 1967), *rev'd* [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶91,565 (S.D. Cal. 1964), *cert. granted*, 390 U.S. 942, *cert. dismissed*, 393 U.S. 801 (1968).

¹⁴ 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part & remanded*, 422 F.2d 1124 (4th Cir. 1970).

method of imposing liability and that therefore the special defenses found in the Acts do not apply. They also illustrate the use of agency doctrine as an alternative to the controlling persons sections.

Both the *Kamen* and *Hopkins* cases involved allegations that brokerage firms should be liable for the activities of their employees. In the *Kamen* case a brokerage firm gave two employees, Ross and Grossinger, the responsibility of obtaining the listed business of over-the-counter nonmember broker-dealers. The two men engaged in illegal activities by making repurchase guarantees to various broker-dealers. In the *Hopkins* case, W. E. Hutton & Co., a stock brokerage firm, was employed by Trice Production Company to act as agent in the sale of production payments carved out of certain oil and gas properties owned by Trice. In the course of the sale to Hopkins, misrepresentations and omissions were made by LaPiere, manager of Hutton's oil and gas department. Hopkins sued Hutton for rescission of the transaction.

Both cases presented obvious opportunities for arguments to be made based upon agency principles, since in both cases suit was brought against brokerage firms alleging that their agents had engaged in illegal activities. In the *Hopkins* case, the Fourth Circuit relied upon agency principles to sustain liability against Hutton. It stated that the Hutton partners had given their agent actual and apparent authority to provide Hopkins with information and that the agent had acted within the scope of his employment in offering the production payments to Hopkins. It concluded, "Hutton is liable, under familiar principles, for the tortious representations of its agent," citing sections of the *Restatement of Agency* to support its conclusion.¹⁵ The use of agency principles to support liability in securities litigation suggests that the semi-codified principles of the common law as set forth in the *Restatement of Agency* and *Restatement of Torts* are becoming part of the securities law civil liability framework.¹⁶

To a certain extent common law principles will naturally provide reference points for application of express and implied liability provisions under securities law.¹⁷ For instance, the *Restatement of Agency*

¹⁵ 422 F.2d at 1130 (citing RESTATEMENT (SECOND) OF AGENCY §§ 257-58 (1958)).

¹⁶ The Fourth Circuit seems to support this view in its *Hopkins* decision. See 422 F.2d at 1130. Likewise, characterization of private remedies under rule 10b-5 as based upon tort theory, carries with it the implication that tort concepts will be utilized to interpret the rule. Ruder, Texas Gulf Sulphur—*The Second Round: Privy and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. REV. 423, 431 (1968). For treatment of the implied private right of action theories, see *id.* 430-33; Comment, *Private Rights From Federal Statutes: Toward a Rational Use of Borak*, 63 Nw. U.L. REV. 454 (1968). See generally Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383, 413-14 (1964).

¹⁷ The creation of implied remedies carries with it analogies to the experience and learning of the common law.

provides several theories of liability that are consistent with accepted securities law policy. First, the principal will be subject to liability for the consequences of his agent's act if the principal intentionally causes that act to be performed.¹⁸ He will also be subject to liability if he is reckless in giving orders, in employing his agents, or in supervising the activity of his agents.¹⁹ He may also be liable for failing to perform a nondelegable duty.²⁰

In terms of the distinction made earlier between liability based upon "primary" activity and liability based upon "secondary" activity, these agency theories can be classed as primary liability theories because liability is premised upon duties owed directly by the principal. In contrast, a separate section of the *Restatement of Agency* providing that the principal will be liable for unauthorized tortious conduct when the "agent" (described as a servant) commits a tort while acting in the scope of his employment²¹ is more properly described as based upon secondary liability concepts. In the latter case the principal (master) has been made liable through application of the definitions of "servant" and "scope of employment" unrelated to the principal's direct participation in the prohibited conduct.²²

Application of ordinary agency doctrine to fraudulent misrepresentations of agents acting within the scope of their employment may in any event be subsumed by section 257, which deals specifically with liability for loss caused by misrepresentations of an agent.²³ Section 257 provides:

A principal is subject to liability for loss caused to another by the other's reliance upon a tortious representation of a servant or other agent, if the representation is:

- (a) authorized;
- (b) apparently authorized; or
- (c) within the power of the agent to make for the principal.²⁴

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¹⁸ RESTATEMENT (SECOND) OF AGENCY § 212 (1958). See also 4 RESTATEMENT OF TORTS §§ 870, 876, 877 (1939).

¹⁹ RESTATEMENT (SECOND) OF AGENCY § 213 (1958).

²⁰ *Id.* § 214.

²¹ *Id.* § 219(1).

²² *Id.* §§ 220-27 (who is a servant), §§ 228-37 (scope of employment). These sections and definitions are thought by many to offer the courts an opportunity to apply the so-called "deep pocket" doctrine, by which liability in an appropriate case can be placed upon the party most able to bear the loss.

²³ *Id.* § 257.

²⁴ *Id.*

The question whether an agent is authorized, apparently authorized, or possesses so-called agency power may be a complicated one.²⁵ In the *Hopkins* case, the Hutton firm was held liable for the misrepresentations of its agents even though it did not know of or authorize those representations. The court held that Hutton's agent possessed sufficient apparent authority to subject Hutton to liability under "familiar [agency] principles."²⁶ In so doing the court evaluated the reasonableness of the representations made by the Hutton agent.

A different result was reached in the *Kamen* case, utilizing the same principles. There the court found that it could not reasonably have appeared to the plaintiff that the defendant's agents were acting in a way that their employer would have authorized. Since the guaranteed profit plan offered by the agents was patently unusual, the court held that the plaintiff should have inquired further regarding the agents' authority.²⁷

The above illustrative discussion of agency theory suggests that courts will not hesitate to apply the "familiar principles" of the *Restatement of Agency* in appropriate cases. This agency approach carries a basic limitation, however, since use of agency theory depends in the first instance upon the existence of an agency relationship.²⁸ Unless the agency relationship exists, agency theory cannot be utilized. As a result, plaintiffs will often find it difficult to use agency theory. If the many possible secondary defendants, such as banks, accountants, lawyers and others, have neither agreed to act for the primary wrongdoer nor agreed that he may act for them, the search for a so-called "deep pocket defendant" in the securities law field will turn to other legal theories.

B. The Contention That the Controlling Persons Provisions Provide an Exclusive Remedy

In both the *Kamen* and *Hopkins* cases defendants denied liability under the controlling persons sections, arguing that they did not have

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²⁵ This complexity is found in *Restatement* sections that intertwine tort and contract questions when dealing with misrepresentations. For example:

If the statement is one which, if true, the agent would be authorized or apparently authorized to make, the principal is subject to liability for it, although deceitfully made, in accordance with the principles underlying the rules stated in Sections 162 and 196. A general agent can bind his principal by representations made within the scope of his power to act, as stated in Section 161, although he is neither authorized nor apparently authorized, and although the principal is undisclosed, as stated in Section 194. False representations with regard to his authority made by the agent to one dealing with him do not cause the principal to be liable in deceit.

Id. § 257, comment a.

²⁶ 422 F.2d 1124, 1130 (4th Cir. 1970).

²⁷ 382 F.2d at 696.

²⁸ An agency relationship exists only if there has been a manifestation of willingness and consent by both the agent and the principal that the agent is to act for the principal. See *RESTATEMENT (SECOND) OF AGENCY* § 15 (1958).

reasonable grounds to believe that the fraudulent activities of their agents were taking place. They argued further that the controlling persons provisions of the securities laws provide the exclusive method of imposing liability upon secondary defendants.²⁹ Although the question was not treated explicitly by either the district court or the court of appeals in the *Kamen* case, it was treated in proceedings before the Supreme Court. The SEC prepared a brief supporting plaintiff's petition for certiorari,³⁰ and after certiorari was granted³¹ filed a brief as amicus curiae.³² These two briefs and the *Kamen* decision were commented upon extensively by the district court in the *Hopkins* case³³ and that court's interpretation was endorsed by the Fourth Circuit.³⁴ In combination, these cases and the SEC briefs amount to substantial authority regarding the exclusivity question.

The Commission's concern regarding the outcome of the *Kamen* case in part rested upon the special nature of the activity involved.³⁵ It argued that liability of a broker-dealer for violations of the anti-fraud provisions of the federal securities laws by employees of the firm is not restricted by the controlling persons provisions of the federal securities laws.³⁶ Secondly, it argued that a violation of the securities laws by employees of a broker-dealer acting within the scope of their employment is necessarily a violation by the firm itself and that the degree of fault on the part of the firm is a factor to be considered only in determining the sanction, if any, to be imposed.³⁷

²⁹ See *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970).

³⁰ Brief for SEC as Amicus Curiae on Petition for Certiorari, *Paul H. Aschkar & Co. v. Kamen & Co.*, 390 U.S. 942 (1968).

³¹ 390 U.S. 942 (1968). The writ was later dismissed by agreement between the parties. 393 U.S. 801 (1968).

³² Brief for SEC as Amicus Curiae, *Paul H. Aschkar & Co. v. Kamen & Co.*, 390 U.S. 942 (1968) [hereinafter cited as SEC Brief].

³³ 297 F. Supp. at 1211-13.

³⁴ 422 F.2d at 1130.

³⁵ Activity involving broker-dealers. See SEC Brief, *supra* note 32, at 1-3.

³⁶ *Id.* 9.

³⁷ *Id.* 14. It stated:

The legislative history of the controlling-persons provisions supports this analysis of their precise focus. The original Senate version of the 1933 Act contained a number of provisions designed "to aid in preventing directors from evading the liabilities incident to signing the registration statement * * *." This draft of the Act dealt with the use of a "dummy" signer of a registration statement and made the fraudulent use of a "dummy" unlawful. The House version, which contained registration and antifraud provisions very much like those eventually adopted, contained no sections expressly dealing either with "dummies" or with controlling persons. In conference these "dummy provisions" which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by one party over the other * * * [were] welded into one and incorporated as a new section in the substitute." The "new section" is what is now the controlling-persons provision of Section 15. Thus, that section was the result of congressional concern with the special problem presented by the use of "dummies", and was not designed to govern the usual employment situation. *Id.* 13-14 (footnotes omitted).

In reaching the first conclusion, the Commission contended that the controlling persons provisions of section 15 and section 20 were not "designed to govern the usual employment situation."³⁸ It argued that traditional agency law would place liability upon the principal if the agent had been actually authorized, apparently or ostensibly authorized, or had acted within his agency powers.³⁹ The Commission continued:

We submit . . . that the controlling-persons provisions under which the court analyzed the federal aspect of petitioner's claim are essentially irrelevant in the ordinary employer-employee context, as exists in this case. These provisions were designed to reach situations in which there are technical legal barriers between the persons in fact responsible for violations of the securities acts and those injured by the violations. . . . [T]he controlling-persons provisions were designed to avoid those barriers by, for example, piercing the corporate veil to reach controlling stockholders. They were intended to enlarge, not restrict, the scope of vicarious liability otherwise arising under the securities acts. Hence, the exceptions set forth in those provisions are applicable only when it is necessary to invoke these expanded premises of liability. Conversely, they are not applicable here because respondents' liability may be and should be determined directly under the antifraud provisions themselves.⁴⁰

In *Hopkins*, the court relied upon the Commission's position in *Kamen* to hold that the section 15 defenses do not apply in the brokerage context when liability is premised upon traditional agency principles. It stated:

What legislative history there is does not indicate that Congress intended Section 15, originally or as amended, to serve as a limitation on liability.⁴¹

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³⁸ *Id.*

³⁹ *Id.* 15 (quoting RESTATEMENT (SECOND) OF AGENCY § 257 & comment *b*, § 261 & comment *a* (1957)).

⁴⁰ SEC Brief, *supra* note 32, at 12-13.

⁴¹ 297 F. Supp. at 1211. The Fourth Circuit agreed. 422 F.2d at 1130. The Commission stated its policy as follows:

Many, probably a majority, of the frauds practiced by securities firms involve misconduct by employees—typically by sales representatives who make false or unfounded representations with respect to securities. It is the Commission's experience that from time to time salesmen actually whet the appetites of gullible public customers by representing that they are breaking their employers' rules by giving them a special deal; for example, by giving them more than the prescribed quota of a new issue of securities. But, whatever the representations made by the salesmen or other employees of the broker-dealer, we have found that investors customarily rely primarily on the integrity, reputation, and responsibility of the firm itself rather than on the character of the particular employee with whom they happen to be dealing. It is the firm that is accepting and retaining the profits from the transactions, as *Kamen & Co.* did in this case; and it is the firm to whom the customer should be permitted and expected to look if his trust has been abused.

SEC Brief, *supra* note 32, at 23.

This latter interpretation is consistent with liberal constructions of other sections of the Securities Acts found in other cases. Good support for the nonexclusivity view appears in cases dealing with implied remedies.⁴² These cases have firmly rejected the contention that the defenses contained in the express provisions of the 1933 and 1934 Acts should be read into remedies granted by implication under the Securities Acts.⁴³ It seems likely that the Commission's position in *Kamen* will prevail and that the specific defenses of the controlling persons sections of the 1933 and 1934 Acts will be available only in those situations in which use of those sections is necessary to impose liability.⁴⁴ If other theories of liability such as agency, aiding and abetting, conspiracy, or direct participation are used, then the "special" defenses of the controlling persons sections will apparently be unavailable.⁴⁵

⁴² The doctrine of implied private remedies is firmly established with respect to: the federal proxy rules, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); the Williams Act takeover legislation, *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969); the Investment Company Act, *Moses v. Burgin*, 445 F.2d 369 (1st Cir.), cert. denied, 404 U.S. 994 (1971); and rule 10b-5, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 92 S. Ct. 165, 169 n.9 (1971). See generally cases cited in *Franklin Nat'l Bank v. L.B. Meadows & Co.*, 318 F. Supp. 1339, 1341-43 (E.D.N.Y. 1970). Attacks have been made upon the validity of the private rights doctrine and considerable debate has ensued regarding the desirability of the doctrine. See Comment, *Private Rights From Federal Statutes: Toward a Rational Use of Borak*, 63 Nw. U.L. Rev. 454 (1968), and articles cited in Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289-90 n.4 (1971).

⁴³ For instance, such arguments have been rejected with regard to the statute of limitations, *Jordan Bldg. Co. v. Doyle, O'Connor & Co.*, 401 F.2d 47, 50-51 (7th Cir. 1968), rev'g 282 F. Supp. 87, 92-93 (N.D. Ill. 1967). For extensive discussion and support for creation of a federal statute of limitations based upon the 1- and 3-year statutes contained in the 1933 and 1934 Acts, see A. BROMBERG, *SECURITIES LAW: FRAUD* §12.9 (1967); 6 L. LOSS, *SECURITIES REGULATION* 3898-900 (Supp. 1969); Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635 (1967); Israels, Book Review, 77 YALE L.J. 1585, 1591 (1968). With regard to buyer's remedies, see *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

⁴⁴ This prediction of outcome should not be interpreted as acquiescence by the author in the predicted result. See generally articles cited in Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289-90 n.4 (1971).

⁴⁵ Compare text following note 180 *infra*.

Strangely, an opposite conclusion may result through recent developments in the implied remedies field. The cases supporting implication of remedies have done so with differing degrees of preciseness and with differing attitudes. The most liberal approach has been taken by the Seventh Circuit in *Jordan Bldg. Corp. v. Doyle, O'Connor & Co.*, 401 F.2d 47 (7th Cir. 1968). In that case, a buyer of securities claimed a private right of action under rule 10b-5 despite the existence of an express similar right under §12(2) of the 1933 Act and an implied private right under rule 15c1-2. In a sweeping statement, the court stated that the remedies supplied under the 1933 and 1934 Acts are "cumulative and not mutually exclusive." *Id.* at 51. Recently, the Tenth Circuit decided *Gilbert v. Nixon*, 429 F.2d 348 (10th Cir. 1970), a case dealing with a rule 10b-5 claim by a buyer who might also have had a private right of recovery under §12(2) of the 1933 Act. Although the court recognized that a private right of action exists under rule 10b-5, it stated its determination to incorporate the provisions of §12(2) into the rule 10b-5 action as follows:

Had appellants invoked Section 12(2) alone our task in formulating the proper legal standards for recovery would have been simplified. We note,

C. Related Theories of Primary Liability

The search for alternative liability theories is not likely to be limited to plaintiffs. Courts are well known for a tendency to support results with alternative doctrine. A good example of this tendency to search for alternate doctrine appears in *Ross v. Licht*.⁴⁶ That case involved the purchase of stock from plaintiffs by corporate insiders at \$120 per share when the insiders knew prospects were good for sales to others at substantially higher prices. The court held that the defendants who controlled and managed the corporation were insiders subject to liability. Three other defendants were dentists who were described as knowledgeable regarding the corporation, but who were neither directors nor employees. All of the defendants were held to have known of the proposed public and private offerings at the time they purchased shares from the plaintiffs.⁴⁷ In dealing with the liability of the dentists, the court attacked the problem in three ways. First, it held that the dentists were corporate insiders because "they had access to information which should be used 'only for a corporate purpose and not for the personal benefit of anyone.'"⁴⁸ Secondly, the court held that if the dentists were not insiders "they would seem to have been 'tippees' (persons given information by insiders in breach of trust) and subject to the same duty as insiders."⁴⁹ Finally, the court held that in

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however, that a private action under Rule 10b-5 originated in the need for a seller's remedy where none had otherwise been provided. Once a remedy was implied for the seller, it was extended to include the buyer even though relief was already available to him under Section 12(2). Since in this case recovery is sought under both provisions, we resolve any conflict between them in favor of Section 12(2), where the statutory remedy is explicit.

Id. at 355 (footnotes omitted). The *Gilbert* case seems to represent a deviation from cases such as *Ellis v. Carter*, 291 F.2d 270, 273-74 (9th Cir. 1961), which have held that the limitations of § 12(2) need not be read into a buyer's action under rule 10b-5. It stands as limited support for the theory that the defenses of the controlling persons sections must be read into secondary liability actions.

Although control was clear in both *Kamen* and *Hopkins*, the question of exclusivity of the controlling persons sections could arise in another context if the control by the defendant over the plaintiffs could not be demonstrated. In that circumstance the defense could contend that if the defendant was not a primary participant in the fraud and neither controlled nor was controlled by a primary participant he should not be liable.

⁴⁶ 263 F. Supp. 395 (S.D.N.Y. 1967).

⁴⁷ 263 F. Supp. at 405. Under familiar rule 10b-5 principles, the corporate insider would be subject to liability for failing to make disclosures while purchasing. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part & rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *on remand*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd in part & rev'd in part*, 446 F.2d 1301 (2d Cir. 1971) (SEC proceeding establishing the elements of a rule 10b-5 violation in the context of a commission injunctive proceeding); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962) (a private action holding that privity of contract is not a necessary element for recovery).

⁴⁸ 263 F. Supp. at 409 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)).

⁴⁹ 263 F. Supp. 410.

any event they "would be equally liable with the other defendants for aiding and abetting a violation of Rule 10b-5."⁵⁰

1. Tippee Liability Distinguished

For several years, the *Ross* case was important because it was the only case in which a court had imposed liability upon a so-called "tip-ping" theory. In setting forth a theory condemning use of inside information received from a corporate insider, the court in the *Ross* case⁵¹ relied upon the concept advanced by Professor Loss that one who knowingly receives information from another in breach of trust should be liable under rule 10b-5 in the same degree as the insider himself.⁵² The *Ross* court also cited *In re Cady, Roberts & Co.*⁵³ as supporting the tippee theory. In that proceeding, the SEC imposed disciplinary sanctions upon a broker who had sold stock of Curtiss-Wright Corporation after receiving a tip from his brokerage partner, who was a Curtiss-Wright director, that the corporation was planning to reduce its dividend. In determining that the broker had violated rule 10b-5, the Commission defined corporate insiders as including "those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities."⁵⁴ It stated:

Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.⁵⁵

This definition was quoted with approval by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*,⁵⁶ but that court seemed to expand the theory by stating that anyone who trades while "in possession of material inside information" owes a duty of disclosure.⁵⁷ The court applied its test by holding that officers and employees, including Darke,

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² 3 L. LOSS, *SECURITIES REGULATION* 1450-51 (2d ed. 1961). Regarding tippee liability generally, see Arnold, *Guidelines for the Banker "Insider" or "Tippee": The Texas Gulf and Merrill Lynch Decisions*, 86 *BANKING L.J.* 319 (1969); Comment, *Deterrence of Tippee Trading Under Rule 10b-5*, 38 *U. CHI. L. REV.* 372 (1971).

⁵³ 40 S.E.C. 907 (1961).

⁵⁴ *Id.* at 912.

⁵⁵ *Id.* (footnote omitted).

⁵⁶ 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

⁵⁷ *Id.*

a geologist, would be considered to have the necessary special relationship. Since the Commission had not brought suit against tippees of those insiders, the Second Circuit was not faced with the tippee liability question. In dictum, however, it stated:

As Darke's "tippees" are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.⁵⁸

Recently, the Commission held in a disciplinary proceeding that tippees have an obligation to refrain from trading based upon inside information. In the *Investors Management* proceeding,⁵⁹ the Commission dealt with use of non-public information by institutional investors. The proceeding involved review of a hearing examiner's decision that certain institutional investors had violated rule 10b-5 by selling stock of Douglas Aircraft Co. without disclosing to the purchasers material information received from Merrill Lynch, Pierce, Fenner and Smith, Inc.⁶⁰ as to a reduction in Douglas earnings. The Commission referred to both the *Cady*, *Roberts* and *Texas Gulf Sulphur* cases, and stated that the requisite elements for the imposition of responsibility upon tippees were:

that the information in question be material and non-public; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction.⁶¹

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⁵⁸ *Id.* at 852-53. The tippee obligation question has been raised in several cases dealing with claims by those who have received false tips. These cases acknowledge existence of a tippee obligation, although reaching different results with regard to whether the defense of *in pari delicto* was available to the defendants. *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969) (defense allowed); *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970) (motion to strike defense overruled); *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971) (defense denied). The *in pari delicto* defense is discussed at text accompanying notes 281-308 *infra*.

⁵⁹ *In re Investors Management Co.*, SEC Securities Exchange Act Release No. 9267, [1970-1971 Transfer Binder] CCH Fed. Sec. L. REP. ¶78,163 (July 29, 1971).

⁶⁰ Although none of the parties petitioned for review of the examiner's decision, the Commission initiated review on its own motion, stating:

since we felt that the legal issues raised respecting the obligations of persons other than corporate insiders who receive non-public corporate information (sometimes referred to as "tippees") had significant implications for the securities industry and investing public, we deemed it appropriate to consider those issues and express our views on them.

Id. at 80,515 (footnote omitted).

⁶¹ *Id.* at 80,519 (footnote omitted).

It rejected contentions that the recipient himself must occupy a special relationship to the issuer and that he must have actual knowledge that information was disclosed in breach of a fiduciary duty.⁶²

The similarity between the standard adopted for so-called "tippees" by the SEC in the *Investors Management* case and the standard in existence for corporate insiders points to the conclusion that the liability of tippee defendants is not "secondary," but is "primary." Their liability is dependent directly upon use of non-public inside information for their own benefit. It does not depend upon their indirect participation in the activities of the primary wrongdoers.

The Commission apparently subscribed to this view, since it dealt with tippee liability questions entirely in the direct sense. It did not discuss at all the finding of the hearing examiner that the respondents had "aided and abetted violations of the antifraud provisions."⁶³

2. Tort Theories and State of Mind

A fertile source of additional doctrine lies in the tort law dealing with deceit.⁶⁴ This theory imposes liability upon a defendant for breach of an obligation that is his alone, so that his violation becomes primary rather than secondary. The deceit theory raises the further possibility that a dividing line may be constructed based upon differences in the degree of fault, which in turn may be derived from concepts of state of mind and foreseeability of result.

A good illustration of the use of the deceit theory to impose primary liability can be found in the accountant's liability field, in which

⁶² *Id.* at 80,520. The Commission's rejection of the necessity of actual knowledge is ambivalent regarding support for a negligence standard for rule 10b-5. The opinion did not require that the recipient have actual knowledge that the information was non-public or that he have actual knowledge that it had been disclosed in a breach of a fiduciary duty not to reveal it. The Commission instead used the term "reason to know" and identified the circumstances that should be examined, including "the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relation to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts." *Id.* at 80,520-21. Commissioner Smith's concurring opinion, *id.* at 80,523-24, seems to make clear that the majority attempted to reject entirely the proposition that a showing must be made that the recipient knew or had reason to know that the information was disclosed in a breach of fiduciary duty not to reveal it. Instead, the Commission acknowledged that there might be "responsibility" when the recipient innocently came into possession of and used information he had reason to know was intended to be confidential. *Id.* at 80,519 n.18.

In answer to the contention that "remote tippees" should not be responsible, the Commission indicated that such tippees would also be responsible if sufficient proof of the requisite knowledge were shown. *Id.* at 80,521.

⁶³ *Id.* at 80,515.

⁶⁴ The *Restatement of Torts* has been partially revised, so that portions of it may be cited as *Restatement (Second) of Torts*, bearing a date of 1965. The pertinent portions of the earlier revision bear a date of 1939. The section dealing with Chapter 22, entitled "Misrepresentation and Nondisclosure in Business Transactions" has not yet been revised, but is contained in a so-called tentative draft of the *Restatement*, Tentative Draft No. 10 (1964) of the *Second Restatement*.

*Fischer v. Kletz*⁶⁵ is currently a leading case. That case was a class action against the Yale Express System, Inc. (Yale), and other defendants, including Yale's accountant, Peat, Marwick, Mitchell & Co. (PMM). The complaint alleged that the plaintiffs had been induced to purchase securities of Yale through the use of misleading financial statements. PMM had certified the financial statements contained in the company's annual report for the year 1963. Subsequently PMM discovered that the figures in the annual report were false and misleading. During a substantial period following discovery of the false figures, Yale issued unaudited interim statements based in part upon the certified financial figures for 1963. PMM did not disclose its findings until May of 1965. The plaintiffs asserted that PMM was "liable in damages for its failure to disclose not only that the certified financial statements in the 1963 annual report contained false and misleading figures but also that the interim statements issued by Yale were inaccurate."⁶⁶

One of the three separate wrongs alleged in the complaint was that PMM had failed to disclose to the public that its previously certified financial reports were false and misleading. The court denied PMM's motions to dismiss on this count.⁶⁷ In so doing, it relied on common law principles as enunciated in the *Restatement of Torts*. The court concluded that an accountant's act of certification is similar in effect to a representation made in a business transaction, since both supply information naturally and justifiably relied upon by individuals for decisional purposes.⁶⁸ It concluded that facts could exist under which PMM might have had a duty to disclose. As discussed in *Fischer*, this liability is primary, since it involves breach of direct obligations to the public.

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⁶⁵ 266 F. Supp. 180 (S.D.N.Y. 1967). For discussions of accountants' liability, see Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959); Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 FORD. L. REV. 19 (1967); Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436 (1964); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DEPAUL L. REV. 56 (1968); Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137 (1967); Comment, *Accountant's Common Law Liability to Third Persons for Misrepresentation*, 57 CALIF. L. REV. 281 (1969); Comment, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967); Comment, *Accountant's Liability*, 20 DRAKE L. REV. 411 (1971); Comment, *Auditor's Liability to Third Parties*, 17 LOYOLA L. REV. 354 (1970); Comment, *Potential Liability of Accountants to Third Parties for Negligence*, 41 ST. JOHN'S L. REV. 588 (1967); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. U.L. REV. 139 (1968).

⁶⁶ 266 F. Supp. at 183.

⁶⁷ *Id.* at 188.

⁶⁸ *Id.* at 186.

The *Fischer* case also discussed the possibility of rule 10b-5 liability, although it did not decide that issue.⁶⁹ The intimations in the *Fischer* case and others that direct duties imposed under common law tort theory also arise under rule 10b-5 suggest that securities law policies may develop by following common law doctrines. A few of those doctrines merit closer examination.

The 1939 edition of the *Restatement of Torts* states in section 531 that:

the maker of a fraudulent misrepresentation is subject to liability . . . only to those persons to whom it is made with the intent to cause them to act in reliance upon it and to such persons only for the pecuniary harm suffered by them by relying upon it in the transaction or type of transaction in which the maker intended to influence their conduct.

This statement represents a relatively limited view of liability because it requires intentional misconduct and limits the kinds of transactions in which liability could be asserted.

Current American Law Institute drafts in this area contain proposed revised sections that expand liability. Proposed section 531 of the *Restatement of Torts* reads as follows:

One who makes a fraudulent misrepresentation is subject to liability for pecuniary loss

- (a) to the persons or class of persons whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation; and
- (b) for pecuniary loss suffered by them through their reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced.⁷⁰

This section deals with so-called "fraudulent" misrepresentations, characterized as including representations that are "consciously false."⁷¹

In addition to this liability based upon conscious misrepresentation, the *Restatement* drafters have embraced a theory of negligent misrepresentations under revised section 552:

Section 552. Information Negligently Supplied for the Guidance of Others

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⁶⁹ *Id.* at 194.

⁷⁰ RESTATEMENT OF TORTS § 531 (Tent. Draft No. 10, 1964), *discussed*, 41 ALI PROCEEDINGS 490 (1964).

⁷¹ RESTATEMENT OF TORTS, Explanatory Notes § 552, comment 8 at 98 (Tent. Draft No. 10, 1964).

(1) One who, in the course of his business, profession or employment, or a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon such information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered

- (a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
- (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.⁷²

Although the revised section is poorly drafted, it could be read to create liability to a large class of persons for an accountant who negligently prepares a financial statement and transmits it to a corporation. The class would be composed of those persons whom he knows will receive the statements and rely upon them. In the typical case, the class could include investors relying upon corporate financial statements contained in annual reports and SEC filings.

These sections dealing with liability for misrepresentations emphasize two factors—the state of mind of the person making the misrepresentation and the likelihood that the information will be used by a person who will suffer damage as a result of such use. The drafters state their concern with expanded liability with two comments. Regarding intentional misrepresentation they state:

Where a misrepresentation is fraudulent, and results in pecuniary loss, the liability of the maker extends . . . to any of the general class of persons whom he intends or has reason to expect to act in reliance upon it, and to loss suffered by them in any of the general type of transactions in which he intends or should expect their conduct to be influenced.⁷³

In an early comment on the question of how far liability for negligent misrepresentation should be extended, the *Restatement* drafters stated:

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⁷² RESTATEMENT OF TORTS § 552 (Tent. Draft No. 12, 1966), *discussed*, 43 ALI PROCEEDINGS 431 (1966).

⁷³ RESTATEMENT OF TORTS, Explanatory Notes § 552, comment *j* at 27 (Tent. Draft No. 12, 1966).

The problem is to find language which will eliminate liability to the very large class of persons whom almost any negligently given information may foreseeably reach and influence, and limit the liability, not to a particular plaintiff identified in advance, but to the comparatively small group whom the defendant expects and intends to influence.⁷⁴

The latter comment seems to take the view that when a misrepresentation is merely negligent the actor should be liable to a narrower class of persons and for a lesser amount. This concern with the drastic nature of an expanded remedy based upon negligence is demonstrated in the decisions of common law courts that have dealt with liability of accountants, who are the group most often involved in preparing statements for the use of the public. State of mind and foreseeability have influenced results in the three most frequently cited accountants cases, *Ultramares Corp. v. Touche*,⁷⁵ *State Street Trust Co. v. Ernst*,⁷⁶ and *Rusch Factors, Inc. v. Levin*.⁷⁷ The *Ultramares* case was an action in tort for damages suffered because of misrepresentations by accountants. The accountants had prepared inaccurate financial statements knowing that they would be used to secure credit. Plaintiffs loaned money in reliance on the statements. Judge Cardozo contrasted liability for fraud and that for negligence, stating that for fraud the accountants should be liable to both their employer and to "creditors and investors to whom the employer exhibited the certificate."⁷⁸ He denied liability to that

⁷⁴ RESTATEMENT OF TORTS, Explanatory Notes § 552 at 56 (Tent. Draft No. 11, 1965). The drafters' comment was included as a caveat to proposed revisions of § 552 when those revisions were considered by the American Law Institute in 1965. Tentative Drafts No. 10 and 11 of the Restatement included the comment in order to indicate lack of agreement on the language of proposed § 552. The drafters were uncertain as to how far liability for negligent misrepresentation should extend. In the 1966 American Law Institute proceedings prior to the adoption of Tentative Draft No. 12 (which did not contain the comment) the Reporter (Dean Prosser) stated:

The Reporter's best guess . . . is that it is enough that there is a limited class of persons—and by "limited" I would say probably not more than a couple of dozen—whom the defendant is himself seeking for his own purposes to reach, or whom he knows that a recipient of the information is going to try to reach . . . I think we need intent to reach a particular class of people.

43 ALI PROCEEDINGS 415 (1966).

Comments made at the ALI Proceedings suggest caution in applying *Restatement* principles to securities laws. Apparently the drafters did not consider the effect of their work upon the securities laws. In response to a question regarding the effect of proposed § 551 on rule 10b-5, Dean Prosser stated:

Anything under the SEC we regarded as statutory and simply left out of this draft. This draft has no reference to that in any way, any more than it has to decisions under various statutes. We are stating common law, and not statutes.

42 ALI PROCEEDINGS 380 (1965).

⁷⁵ 255 N.Y. 170, 174 N.E. 441 (1931).

⁷⁶ 278 N.Y. 104, 15 N.E.2d 416 (1938).

⁷⁷ 284 F. Supp. 85 (D.R.I. 1968).

⁷⁸ 255 N.Y. at 179, 174 N.E. at 444.

same class for negligence, however, with the statement that it "may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁷⁹ In the *State Street Trust* case, the New York Court of Appeals imposed liability on accountants who heedlessly and recklessly prepared financial statements upon which a lender relied.⁸⁰

In the *Rusch Factors* case the defendant accountant knew that his certification was intended to induce reliance by potential lenders to a Rhode Island corporation. Reviewing precedent the court stated, "Privity of contract is clearly no defense in a fraud action," adding that "an intentionally misrepresenting accountant is liable to all those persons whom he should reasonably have foreseen would be injured by his misrepresentation."⁸¹ It also equated heedless conduct with intentional conduct, stating that "the same broad perimeter prevails if the misrepresenter's conduct is heedless enough to permit an inference of fraud."⁸² Applying the foreseeability test, it stated that the accountant need not have actual knowledge of the third person's reliance, and that there are no limitations on the number of persons in the class.⁸³

It supported this "broad rule of liability for fraudulent misrepresentation" as follows:

First, liability should extend at least as far in fraud, an intentional tort, as it does in negligence cases resulting in personal injury or property damage. Second, the risk of loss for intentional wrongdoing should invariably be placed on the wrongdoer who caused the harm, rather than on the innocent victim of the harm. Finally, a broad rule of liability may deter future misconduct.⁸⁴

The court also suggested, without deciding, that liability for professional malpractice might be extended to a foreseeable class composed of the "investing and lending public."⁸⁵ It stated:

Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost on to the entire consuming public?

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⁷⁹ *Id.* at 179, 174 N.E. at 444.

⁸⁰ 278 N.Y. at 112, 121, 15 N.E.2d at 419, 423.

⁸¹ 284 F. Supp. at 90.

⁸² *Id.*

⁸³ *Id.* at 91.

⁸⁴ *Id.* at 90.

⁸⁵ *Id.* at 91.

Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? ⁸⁶

Despite this apparent willingness to extend the theory, the court indicated that the plaintiff was a single party whose reliance was actually foreseen by the defendant. It held that "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons." ⁸⁷

These common law doctrines of foreseeability and state of mind undoubtedly will influence the development of securities law liabilities, particularly under rule 10b-5. Their applicability may be particularly important in situations in which special duties are owed. In *Fischer v. Kletz*,⁸⁸ the court concentrated its analysis upon direct breach of a duty by the defendant accountants. Attention to separate duties owed by professionals such as accountants and brokers emphasizes that in a complicated case involving numerous defendants liability may be imposed without resort to secondary liability theories if the existence of an independent duty to the public by virtue of special professional status can be shown. Additionally, the common law technique of measuring liability based upon defendant's state of mind, including foreseeability, is one that should prove useful not only in analyzing direct liability cases ⁸⁹ but also in deciding which defendants should be liable under secondary theories.

D. Privity of Contract

Although questions regarding state of mind and foreseeability taken alone raise important questions for primary defendants, these questions become increasingly important when considered in the context of the current tendency toward elimination of privity of contract in securities law cases. Under developing doctrines both primary and secondary defendants in securities law fraud cases may find themselves liable to many more persons than those with whom they have had dealings. Until about 1962, the prevailing view under rule 10b-5 was that privity of contract was required between an injured plaintiff and a defendant. The most widely quoted statement appeared in *Joseph v. Farnsworth Radio & Television Corp.*:⁹⁰

A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, prac-

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⁸⁶ *Id.*

⁸⁷ *Id.* at 93.

⁸⁸ 266 F. Supp. 180 (S.D.N.Y. 1967).

⁸⁹ See Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423 (1968).

⁹⁰ 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

tice or course of business was invoked seems to be requisite.

. . .⁹¹

Subsequently, however, numerous courts have held that no privity requirement exists. One of the earliest of these cases was *Cochran v. Channing Corp.*,⁹² in which the plaintiffs in a class action alleged that the corporate insiders had omitted the company's dividend for the purpose of causing the price to decline so that they could purchase shares on the open market. The plaintiffs failed to allege that they had sold their stock to the insider purchasers.⁹³ The court denied a motion to dismiss, stating, "[T]he fact that there is no privity of contract does not amount to a fatal defect of proof."⁹⁴ Other courts have followed the lead of the *Cochran* court and have held that privity of contract is not a required element.⁹⁵

The *Texas Gulf Sulphur* litigation illustrates problems currently being raised by developing doctrines that the plaintiff need not show a contractual relationship with the defendant. In *Mitchell v. Texas Gulf Sulphur Co.*,⁹⁶ the Tenth Circuit affirmed imposition of liability upon Texas Gulf Sulphur for a misleading press release, stating that "the common law requirement of privity has all but vanished from 10b-5 proceedings."⁹⁷ The court allowed recovery on behalf of three plaintiffs, even though the company had not engaged in any securities transactions.⁹⁸

The elimination or reduction of the element of privity as a factor in determining liability is, of course, an important one for secondary

⁹¹ *Id.* at 706.

⁹² 211 F. Supp. 239 (S.D.N.Y. 1962).

⁹³ *Id.*

⁹⁴ *Id.* at 245.

⁹⁵ See, e.g., *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd & remanded on other grounds sub nom.* *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242, 249 (6th Cir. 1962) (plaintiff may maintain action against original sellers of bonds although he had not purchased directly from them); *Freed v. Szabo Food Serv. Inc.*, [1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964) (plaintiffs have claim against misrepresenting corporation even though the corporation did not engage in a securities transaction); *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33, 37 (E.D. Pa. 1964) (purchasers may maintain action based upon misleading reports filed with the SEC although defendants had not traded: "[I]f 'a semblance of privity' means 'privity' (like 'a little bit pregnant'), I reject it"); *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968) (class actions by purchasers based upon misleading financial statements can be maintained, since "[t]here is no necessity for contemporaneous trading in securities by insiders or by the corporation itself").

⁹⁶ 446 F.2d 90 (10th Cir. 1971), *aff'g* *Reynolds v. Texas Gulf Sulphur Co.*, 309 F. Supp. 548 (D. Utah 1970), *cert. denied*, 40 U.S.L.W. 3399 (1972).

⁹⁷ 446 F.2d at 101.

⁹⁸ *Id.* For discussions of privity in terms of the "in connection with" requirement, see *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968); *Financial Indus. Fund v. McDonnell Douglas Corp.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,004 (D. Colo. 1971).

defendants. Nevertheless, in order for liability to exist, someone must have engaged in activity that violates the rule. Abolition of the privity requirement makes the potential damage for a secondary defendant greater, and emphasizes that careful attention should be given to identification of the elements required for secondary liability.

E. *Conspiracy and Aiding and Abetting*

1. Conspiracy and Aiding and Abetting Defined and Distinguished

As noted earlier, tort theory has been a fertile source of doctrine under rule 10b-5 and other securities laws. The general statement of secondary liability appearing in section 876 of the *Restatement of Torts*⁹⁹ has been seized upon by some courts as providing a source of liability for secondary defendants. That section contains the following language:

876. Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

- (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
- (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
- (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.¹⁰⁰

The *Restatement* view has been advanced in *Brennan v. Midwestern United Life Insurance Co.*,¹⁰¹ which is to date the most important securities law case dealing with secondary liability. That case involved a class action by purchasers who had bought stock of Midwestern United Life Insurance Company from Michael Dobich and Dobich Securities Corporation but who had failed to receive delivery of their stock. Dobich had been dealing fraudulently with his customers' money in violation of the securities laws. The plaintiff claimed that Midwestern

⁹⁹ RESTATEMENT OF TORTS § 876 (1939).

¹⁰⁰ *Id.*

¹⁰¹ 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

should be liable because it had knowingly assisted Dobich in his fraud. The trial court relied in part upon tort theories, quoting section 876 of the *Restatement of Torts*¹⁰² in its first decision, which denied defendant's motion to dismiss the claim for failure to state a cause of action.¹⁰³ Although not relying directly on section 876 in its decision on the merits, the court stated that the general concept of aiding and abetting "has been formulated in a most helpful manner in the Restatement of Torts § 876."¹⁰⁴

Since section 876 of the *Restatement of Torts* deals primarily with liability for physical harm rather than liability in the business or economic setting, it should be relied upon with caution in invoking securities law liability. Nevertheless, the concepts introduced may be useful. Subsection (a) of section 876 places secondary liability upon a person who orders or induces tortious conduct knowing of the conditions under which the act is done or intending the consequences that ensue. This section parallels the agency principles examined earlier in this Article and encompasses a type of primary liability.

Clause (b) accords most clearly with the aiding and abetting theory of secondary liability. According to the *Restatement* comment, liability requires both that the act is known to be tortious and that the encouragement or assistance is a substantial factor in causing the resulting tort.¹⁰⁵

Clause (c) deals with a situation in which the assistance is substantial, but the person engaging in the activity does not know that the act of the primary participant is tortious. The comment to Clause (c) states the following:

Where a person personally participates in causing a particular result in accordance with an agreement with another, he is responsible for the result of the united effort if his act, considered by itself, constitutes a breach of duty and is a substantial factor in causing the result, irrespective of his knowledge that his act or the act of the other is tortious.¹⁰⁶

This section does not specify the nature of the duty owed by the secondary participant. It does, however, require that the participation be "in accordance with an agreement" with the primary tortfeasor. The comments to this section relate only to minor physical harms.¹⁰⁷ The

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¹⁰² RESTATEMENT OF TORTS § 876 (1939).

¹⁰³ 259 F. Supp. at 680.

¹⁰⁴ 286 F. Supp. at 708.

¹⁰⁵ RESTATEMENT OF TORTS § 876, comment *b* at 436.

¹⁰⁶ *Id.*, comment *c* at 439.

¹⁰⁷ *Id.* Each of the illustrations relates to physical activities and recites a situation in which the secondary participant is not liable.

section offers little helpful analysis and properly should be rejected as an independent source of liability under the securities laws.

Although the lower court in the *Brennan* case utilized tort principles, it also analyzed the securities law doctrine of aiding and abetting, rejecting a claim that Congress had by implication excluded aiding and abetting activities from coverage by the securities laws.¹⁰⁸ It concluded that since the 1934 Act was broad and remedial it "should not easily be rendered impotent to deal with new and unique situations within the scope of the evils intended to be eliminated."¹⁰⁹ It stated:

In the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes. In this regard, it cannot be said that civil liability for damages, so well established under the Securities Exchange Act of 1934, may never under any circumstances be imposed upon persons who do no more than aid and abet a violation of Section 10(b) and Rule 10b-5.¹¹⁰

Before coming to this conclusion the district court discussed the disclosure obligations of corporations and concluded that since disclosure was a protection for investors, the securities law should be directed toward that end. It stated:

The effect on an investor of an issuer corporation's failure to disclose improper activities of a brokerage firm dealing heavily in the issuer's stock, where the broker's activities create an appreciable risk of loss to that investor, may be just as dangerous and equally as damaging as a failure by the issuer to disclose information of its own improper activities affecting the value of its stock. The loss to the investor may well be the same.¹¹¹

The Seventh Circuit approved the latter quoted language.¹¹²

It might be urged that the Seventh Circuit's approval of the district court's statement amounts to an implied statement that an affirmative disclosure obligation with regard to corporate activities exists and that such an affirmative disclosure obligation should be extended to include the corporation's knowledge of improper activities affecting its own stock. To construe the *Brennan* decision as imposing an affirmative obligation would amount to a remarkable advance in the imposition of direct liability upon a corporation. Thus far, no case has held that

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¹⁰⁸ 259 F. Supp. at 678.

¹⁰⁹ *Id.* at 680.

¹¹⁰ *Id.* at 680-81.

¹¹¹ *Id.* at 680.

¹¹² 417 F.2d at 155.

an affirmative obligation to disclose inside information exists in the absence of trading or other factors. The *Brennan* case need not be read as imposing such an obligation.¹¹³ It is better considered as a landmark case establishing that liability may be imposed upon a defendant who himself was not a primary participant in a securities law fraud, but who assisted or conspired with the primary participant.

In its *Brennan* decision, the Seventh Circuit stated that a secondary defendant may be liable for giving active and knowing assistance to a third party engaged in fraudulent activities violating the securities laws. It reached that conclusion only after acknowledging the existence of an independent securities law violation. In establishing liability for giving knowing assistance to that violation the court left many questions unanswered. Those questions include the following:

- (1) To what extent must the secondary defendant's knowledge of the primary defendant's activities be shown?
- (2) To what extent must the secondary defendant's knowledge of the illegality of those activities be shown?
- (3) What is the nature of the agreement or assistance required?

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¹¹³ Despite the absence of such an affirmative disclosure obligation, the kinds, types, and numbers of factors that will give rise to such an obligation seem to be increasing. For instance, an obligation may exist to correct a prior incorrect statement, *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); there may be a continuing obligation to disclose events that make prior statements untrue, *SEC v. Shattuck Denn Mining Corp.*, 297 F. Supp. 470 (S.D.N.Y. 1968). The stock exchanges have implemented so-called timely disclosure practices. For instance, the *New York Stock Exchange Company Manual* states:

A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities. A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

NEW YORK STOCK EXCHANGE COMPANY MANUAL A-18 (1968). Additionally, in October 1970 the SEC announced that:

[A company] has an obligation to make full and prompt announcements of material facts regarding the company's financial condition.
[1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶77,915, SEC Securities Act Release No. 5092 (Oct. 15, 1970). It continued by stating the following:

Not only must material facts affecting the company's operations be reported; they must also be reported promptly. Corporate releases which disclose personnel changes, the receipt of new contracts, orders and other favorable developments but do not even suggest existing adverse corporate developments do not serve the public needs and may violate the anti-fraud provisions of the Securities Exchange Act of 1934 . . . .

The policy of prompt corporate disclosure of material business events is embodied in the rules and directives of the major exchanges. It should be noted that unless adequate and accurate information is available, a company may not be able to purchase its own securities or make acquisitions using its securities, and its insiders may not be able to trade its securities without running a serious risk of violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Id.

Discussion of these questions and others requires consideration of the historical background of aiding and abetting liability, as well as securities law policies.

In the securities law field, aiding and abetting doctrines have been utilized frequently by the SEC in its disciplinary proceedings. For instance, in *SEC v. Barraco*,¹¹⁴ the Commission brought suit against Barraco seeking injunctive relief for violation of net capital requirements¹¹⁵ and bookkeeping rules.¹¹⁶ The suit also sought an injunction against the officers of the corporation, both directly and as aiders and abettors. The court dealt with the contention that the rules upon which the Commission was proceeding applied only to brokers and dealers and not to their officers.¹¹⁷ Concerning its inherent powers to issue injunctions against corporate officers,¹¹⁸ it concluded:

It could hardly make any difference in respect to the court's inherent power to deal with contributors what term or designation might be employed in relation to them. Here the Commission, apparently as a matter of convenience and uniformity for purpose of its complaints and decrees, has chosen to use the term "aiders and abettors" in general designation of any such persons as have contributingly played a part in the doing or commission of an enjoined act by another.¹¹⁹

The *Barraco* case illustrates the SEC's frequent use of the phrase "aider and abettor" in Commission actions in order to ensure that sanctions can be broadly imposed. Since the term has been limited primarily to use in SEC disciplinary and injunctive proceedings, the SEC's broad characterization of the doctrine has shed little light on the use of aiding and abetting theories in private damage actions. In another recent case involving a broker-dealer and other defendants, *SEC v. National Bankers Life Insurance Co.*,¹²⁰ the court criticized the Commission's broad use

¹¹⁴ 438 F.2d 97 (10th Cir. 1971).

¹¹⁵ 1934 Act § 15(c)(3), 15 U.S.C. § 78o(c)(3) (1970); SEC Reg. 15c3-1, 17 C.F.R. § 240.15c3-1 (1971).

¹¹⁶ 1934 Act § 17(a), 15 U.S.C. § 78q(a) (1970); SEC Reg. 17a-3, 17 C.F.R. § 240.17a-3 (1971).

¹¹⁷ 438 F.2d at 98.

¹¹⁸ It characterized the grant of injunctive authority under § 21(e) of the 1934 Act, 15 U.S.C. § 78u(e) (1970), as granting power to the Commission to seek the traditional general power of a court of equity to issue injunctions. It stated the following:

That power, as we have discussed, extends to making enjoinder personally of any or all of those who have played a material part in the commission of an enjoined act, contributors as well as principals, where the court deems the enjoinder of a contributor necessary to prevent a recurrence of the act.

438 F.2d at 99.

¹¹⁹ *Id.*

¹²⁰ 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

of the term. After noting that "[a]iding and abetting in the context of this case is an illusive concept,"¹²¹ the court stated:

It is always possible in a complex law suit that a party may become unable to see the forest for the trees. That appears to be the situation in the instant case with the SEC. The SEC has brought suit against a number of defendants that allegedly committed a wide variety of acts. The SEC has sought to paint them all with the same broad brush—claiming that the various activities have made each defendant part of a conspiracy to sell unregistered stock and part of a scheme to defraud. Because of this alleged combined activity, the SEC sought to hold them all jointly liable. In so doing, the SEC, however, failed to distinguish one defendant from the other and failed to properly delineate individual violations.¹²²

Few Securities and Exchange Commission opinions involving the aiding and abetting doctrine have been appealed and only a few non-criminal cases have dealt with either an aiding and abetting or a conspiracy claim against secondary defendants.¹²³ Sufficient cases exist, however, involving claims of either conspiracy or aiding and abetting¹²⁴

¹²¹ *Id.* at 195.

¹²² *Id.* at 197.

¹²³ *Brennan v. Midwestern Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), is by far the most important case in this series.

¹²⁴ Those cases are the following:

1. *Timetrust, Inc. v. SEC*, 142 F.2d 744 (9th Cir. 1944).
2. *In re Matter of Burley & Co.*, 23 S.E.C. 461 (1946).
3. *Fry v. Schumaker*, 83 F. Supp. 476 (E.D. Pa. 1947).
4. *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949).
5. *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955).
6. *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959).
7. *H.L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960).
8. *In re Sutro Bros. & Co.*, 41 S.E.C. 443 (1963).
9. *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).
10. *Jackson Tool & Die, Inc. v. Smith*, 339 F.2d 88 (5th Cir. 1964).
11. *United States v. Re*, 336 F.2d 306 (2d Cir.), *cert. denied*, 379 U.S. 904 (1964).
12. *SEC v. J.P. Howell & Co., Inc.*, 229 F. Supp. 699 (D.N.J. 1962), *aff'd*, 330 F.2d 958 (3d Cir. 1964).
13. *Lorenz v. Watson*, 258 F. Supp. 724 (E.D. Pa. 1966).
14. *Bronner v. Goldman*, 361 F.2d 759 (1st Cir.), *cert. denied*, 385 U.S. 933 (1966).
15. *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), *aff'd* 286 F. Supp. 702 (N.D. Ind. 1968).
16. *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).
17. *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).
18. *Butterman v. Walston & Co., Inc.*, 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968).

to permit an examination of the theories and an attempt to clarify the requisites for liability under each.

In its early application of aiding and abetting and conspiracy doctrines as well as in its later approaches the SEC has tended to rely upon criminal law concepts.¹²⁵ These criminal law concepts offer a good starting point in interpreting substantive doctrines relating to conspiracy and aiding and abetting.¹²⁶ This background may be particu-

19. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).
20. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *modified and aff'd*, 430 F.2d 1202 (9th Cir. 1970).
21. *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968).
22. *Wyndham Associates v. Bintliff*, [1966-1967 Transfer Binder] CCH FED. SEC. LAW REP. ¶ 92,016 (S.D.N.Y. 1967), *aff'd*, 398 F.2d 614 (2d Cir.), *cert. denied*, 393 U.S. 977 (1968).
23. *Donlon Indus., Inc. v. Forte*, [1967-1969 Transfer Binder] CCH FED. SEC. LAW REP. ¶ 92,196 (S.D.N.Y.), *appeal dismissed*, 402 F.2d 935 (2d Cir. 1968).
24. *Gross v. SEC*, 418 F.2d 103 (2d Cir. 1969).
25. *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).
26. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).
27. *Nees v. SEC*, 414 F.2d 211 (9th Cir. 1969).
28. *Wood v. Wood*, 312 F. Supp. 758 (S.D.N.Y. 1969).
29. *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).
30. *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970).
31. *SEC v. Barraco*, 438 F.2d 97 (10th Cir. 1971).
32. *Stead v. SEC*, 444 F.2d 713 (10th Cir. 1971), *cert. denied*, 92 S. Ct. 739 (1972).
33. *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).
34. *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

For general discussion of these doctrines, see 2 A. BROMBERG, *SECURITIES LAW: FRAUD* § 8.5(515) (1971).

¹²⁵ *E.g.*, *In re Burley & Co.*, 23 S.E.C. 461, 466 & n.11 (1946).

¹²⁶ Nevertheless, it seems most likely that the source of conspiracy or aiding and abetting theories as a method of imposing liability upon secondary defendants in securities law situations will be the Securities Acts rather than federal laws relating generally to conspiracy or aiding and abetting, which read:

Conspiracy . . .

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than 5 years, or both.

18 U.S.C. § 371 (1970);

Principals

(a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.

(b) Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

18 U.S.C. § 2 (1970). It seems unlikely that either section of the United States Code will be used directly to imply a private right of action. See *Bryant v. Donnell*,

larly helpful in analyzing the key elements identified above: the existence of the independent securities law violation, knowledge of that violation and its illegality, and the nature of the agreement or assistance rendered by the secondary defendant.

One criminal law definition of aiding and abetting is the following:

Whoever aids, abets, counsels, commands, induces or procures the commission of a crime is punishable as a principal. In order to aid or abet the commission of a crime a person must associate himself with the criminal venture, participate in it, and try to make it succeed.¹²⁷

Similarly a definition of conspiracy under criminal law has been stated as follows:

A conspiracy is a combination of two or more persons to accomplish an unlawful purpose, or a lawful purpose by unlawful means.¹²⁸

The distinction between conspiracy and aiding and abetting was stated in *Pinkerton v. United States*,¹²⁹ a case involving a charge that two brothers had violated the Internal Revenue Code. In his dissent, Justice Rutledge distinguished substantive offenses, aiding and abetting, and conspiracy:

The gist of conspiracy is the agreement; that of aiding, abetting or counseling is in consciously advising or assisting another to commit particular offenses, and thus becoming a party to them; that of substantive crime, going a step beyond mere aiding, abetting, counseling to completion of the offense.¹³⁰

Another statement of the difference appears in *Nye & Nissen v. United States*.¹³¹ In holding that a defendant against whom a conspiracy charge could not be established had aided and abetted the making of misrepresentations in invoices presented to the War Shipping Administration, the court stated:

In order to aid and abet another to commit a crime it is necessary that a defendant "in some sort associate himself with the venture, that he participate in it as in something that he

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239 F. Supp. 681 (W.D. Tenn. 1965). This does not mean that criminal prosecution for aiding and abetting and conspiracy would not be available in an appropriate securities law case. See Brenner, *Selected Jury Instruction Forms in an SEC Criminal Case*, 41 F.R.D. 93, 119-29 (1967).

¹²⁷ Seventh Circuit Judicial Conference Committee on Jury Instructions, *Manual on Jury Instructions in Federal Criminal Cases*, 33 F.R.D. 523, 544 (1963).

¹²⁸ Seventh Circuit Judicial Conference Committee on Jury Instructions, *Manual on Jury Instructions in Federal Criminal Cases*, 36 F.R.D. 457, 503 (1965).

¹²⁹ 328 U.S. 640 (1946).

¹³⁰ *Id.* at 649.

¹³¹ 336 U.S. 613 (1949).

wishes to bring about, that he seek by his action to make it succeed." ¹³²

2. Existence of the Independent Wrong

Whether the liability of the secondary defendant is based upon conspiracy or aiding and abetting, an independent illegal act or venture must exist to which he can attach himself either by agreement or by action. If his own act is unlawful, he becomes the primary violator of the securities law.¹³³ Courts that have imposed liability, administrative sanctions, or criminal penalties upon secondary defendants in securities law cases often do not emphasize the independent wrong requirement, because in most such cases the wrong is easily established. Illustrative cases appear below.

In the leading case in the aider and abettor field, *Brennan v. Midwestern United Life Insurance Co.*,¹³⁴ Michael Dobich and Dobich Securities Corporation were found by the trial court to have been violating the securities laws by dealing in a fraudulent manner with customers' money.¹³⁵ Dobich accomplished his fraud by accepting orders and payments for stock of Midwestern United Life Insurance Company and using his customers' payments to speculate on the commodities market.¹³⁶ Liability was imposed upon Midwestern on the grounds that it knew that Dobich was violating the securities laws and that it had actively aided and abetted him.¹³⁷

In an earlier case, *Pettit v. American Stock Exchange*,¹³⁸ the trustees in bankruptcy of Swan-Finch Corporation alleged that the corporation was injured when Swan-Finch stock was issued to its controlling stockholder, Lowell Birrell, without adequate consideration, and subsequently was resold to the public through manipulative activities joined in by two specialists on the American Stock Exchange. The trustees sued the Exchange, a brokerage firm, and a Swiss bank. The court acknowledged the existence of two fraudulent schemes, the first of which was issuance of shares to Birrell without adequate consider-

¹³² *Id.* at 619 (citing *United States v. Peoni*, 100 F.2d 401 (2d Cir. 1938)).

¹³³ *See, e.g., Reynolds v. Texas Gulf Sulphur Co.*, 309 F. Supp. 548 (D. Utah 1970), *aff'd in part sub nom. Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

¹³⁴ 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

¹³⁵ 417 F.2d at 149.

¹³⁶ Another aspect of this case appears in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

¹³⁷ The difference between active and passive conduct will be discussed at notes 249-53 *infra* & accompanying text.

¹³⁸ 217 F. Supp. 21 (S.D.N.Y. 1963).

ation and the second of which was sale of these shares to the public without registration, in a rigged market.¹³⁹ It characterized the assistance of the various defendants in connection with the illegal distribution of Swan-Finch stock as follows:

[T]he trustees claim that defendant Exchange and its officers aided, abetted, and assisted the illegal distribution of Swan-Finch stock by failing to take necessary disciplinary action against abusive conduct and practices of which they knew or should have known. Defendant Ira Haupt & Co. is accused of having assisted, aided, and abetted the Birrell conspiracy by permitting the Res to open and maintain dummy accounts. The Swiss Bank defendants are accused of similar conduct with respect to their banking facilities, and also of having assisted the concealment of the true identity of traders in Swan-Finch stock, and having aided the sale and delivery of unregistered Swan-Finch stock.¹⁴⁰

In *SEC v. North American Research and Development Corp.*,¹⁴¹ three defendants inaugurated a scheme to buy a publicly owned corporate shell, to dress up that shell with assets that could be represented as having enormous potential value, to funnel the shares into cooperating brokerage houses in Canada, and to tout the stock for sale in America, all for the purpose of selling worthless shares to Americans at great profit. The SEC request for a preliminary injunction alleged that the three primary defendants had violated the Securities Acts by failing to register the securities and by making misrepresentations in connection with their distribution. The lower court granted a preliminary injunction against the three primary defendants, but denied a motion for a preliminary injunction against other defendants. In upholding the preliminary injunction against the three primary defendants and reversing denial of the motion for preliminary injunction against other defendants, the Second Circuit treated the failure to register sale of the securities as an obvious violation of the 1933 Act¹⁴² and the misrepresentations in regard to sale of the securities as obvious violations of Sections 10(b) and rule 10b-5 of the 1934 Act. It thus treated the independent wrongs as clearly established.

Similarly, in *Wessel v. Buhler*¹⁴³ the court dealt with a claim that misrepresentations regarding financial figures had been made in three prospectuses distributed by Rocky Mountain Chemical Corporation

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¹³⁹ *Id.* at 25-26.

¹⁴⁰ *Id.* at 28.

¹⁴¹ 424 F.2d 63 (2d Cir. 1970), *aff'd in part* 280 F. Supp. 106 (S.D.N.Y. 1968).

¹⁴² 1933 Act § 5, 15 U.S.C. § 77e (1970).

¹⁴³ 437 F.2d 279 (9th Cir. 1971).

(RMC). The plaintiff claimed that an accountant, Jordan, who had submitted financial statements to RMC should be liable for damages caused when these statements were incorporated into prospectuses used to sell stock.¹⁴⁴ In one branch of its ruling, the court analyzed an aiding and abetting claim against Jordan by assuming that a misleading prospectus had been issued in violation of the securities laws and then reached the merits of and rejected an aiding and abetting claim against Jordan.¹⁴⁵

The above cases demonstrate the largely unarticulated premise that an independent wrong must exist before aiding and abetting or conspiracy liability can be imposed. Even though the independent wrong is easy to establish in most aiding and abetting and conspiracy cases, exact identification of the wrong is essential in order to determine which persons should be subject to liability for giving knowing assistance to or agreeing with the primary participants in the wrongdoing.

3. The Knowledge Requirement

Once the independent wrong has been established, aiding and abetting liability will depend upon a showing that the defendant knew of the wrong and gave assistance to the wrongdoer. Conspiracy liability will require such knowledge plus an agreement with the wrongdoer.

The existence and nature of a knowledge requirement may become crucial to determining which parties bear liability. As aiding and abetting and conspiracy liabilities in the securities field develop, careful consideration of knowledge requirements is essential in order to achieve sound and balanced policy. For instance, in the Westec litigation it appears that numerous banks loaned money to Westec insiders who in turn used those funds to manipulate the market in Westec stock.¹⁴⁶ If all that is required in order to impose liability for aiding and abetting is that illegal activity under the securities laws exists and that a secondary defendant, such as a bank, gave aid to that illegal activity, the act of loaning funds to the market manipulator would clearly fall within that category and would expose the bank to liability for aiding and abetting. Imposition of such liability upon banks would virtually make them insurers regarding the conduct of insiders to whom they loan money. If it is assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some

¹⁴⁴ The *Wessel* case is discussed at text accompanying notes 201-02 *infra* in connection with attempts to place liability upon Jordan as a direct participant in the production of misleading prospectuses.

¹⁴⁵ 437 F.2d at 283.

¹⁴⁶ See *Carpenter v. Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970), and cases cited note 5 *supra*.

remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. Knowledge of wrongful purpose thus becomes a crucial element in aiding and abetting or conspiracy cases.

The existence of a knowledge requirement in order to impose such liability should be distinguished from the question whether scienter is a necessary element to establish liability for the primary participant. The question whether scienter is a required element under rule 10b-5, the primary federal regulation dealing with securities law fraud, must be regarded as open at this time.¹⁴⁷ The circuit courts are either split or in confusion regarding the existence of a scienter element. The Ninth Circuit has held that scienter is not a required element in a rule 10b-5 action, although the cases asserting this proposition have involved face-to-face rather than market transactions.¹⁴⁸ Similarly the Eighth Circuit has stated that a negligence standard will suffice.¹⁴⁹ The Tenth Circuit has stated that scienter has not been abolished as a factor in a private action under rule 10b-5.¹⁵⁰ Although the Second Circuit has frequently been cited for the proposition that a private right of action under rule 10b-5 exists only when the element of scienter is present,¹⁵¹ its decision in *SEC v. Texas Gulf Sulphur Co.*¹⁵² has introduced doubt regarding the existence of a scienter requirement in that circuit.¹⁵³ Other circuits

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¹⁴⁷ Policy considerations regarding state of mind are discussed in Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968). Other discussions of the scienter problem can be found in Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970); Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108 (1969); Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); Comment, *Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

¹⁴⁸ See *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

¹⁴⁹ *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

¹⁵⁰ It did so in a case in which it selected as its standard that contained in § 12(2) of the 1933 Act, placing the burden upon the defendant to sustain an affirmative defense "that he did not know, and in the exercise of reasonable care could not have known" that a misrepresentation or omission existed. *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102, 104 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), referring to *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970).

¹⁵¹ In reliance upon *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

¹⁵² 401 F.2d 833, 855 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

¹⁵³ See *Marx & Co. v. Diners' Club, Inc.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶92,881 (S.D.N.Y. 1970), reporting that "the extent to which traditional scienter requirements of the common law must be pled and proved in a private damage claim under 10b and X-10b-5 is an open question in this circuit."

have not reached clear positions regarding scienter.¹⁵⁴ Few have discussed the knowledge element in the aiding and abetting setting.

Although elimination of a scienter requirement in order to establish violation by the primary participant may be urged upon the grounds that maximum protection of investors will be provided by requiring exercise of care when engaging in activities that might injure others, different considerations enter into eliminating scienter as an element of aiding and abetting or conspiracy and substituting a duty of inquiry or a "should have known" standard.¹⁵⁵ In most cases, the alleged aider and abettor (or conspirator) will merely be engaging in customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice. If each of these parties

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Id. at 90,296. However, in *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), the Second Circuit reaffirmed its scienter requirement in the brokerage context.

¹⁵⁴ Fourth Circuit: *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970), *aff'g in part & rev'g in part* 283 F. Supp. 128 (D. Md. 1968); *Johns Hopkins Univ. v. Hutton*, 326 F. Supp. 250 (D. Md. 1971); *Batchelor v. Legg & Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 93,119, 93,120 (D. Md. 1971); Fifth Circuit: *Hendricks v. Flato Realty Invs.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,290 (S.D. Tex. 1968); *see Investors Management Co., SEC Securities and Exchange Act Release No. 2967*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163 (1971); Sixth Circuit: *Mader v. Armel*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027 (S.D. Ohio 1971); Seventh Circuit: *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), *aff'g* 208 F. Supp. 808 (E.D. Wis. 1962).

¹⁵⁵ Most securities law aiding and abetting or conspiracy cases have not discussed the knowledge point because knowledge was not in question. In *Fry v. Schumaker*, 83 F. Supp. 476 (E.D. Pa. 1947), the conspiring brokers knew their letter was part of a scheme to defraud; in *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949), Merrill, Lynch, which assisted another broker in violating the securities laws, knew that the broker was misusing his account with Merrill, Lynch; in *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955), the defendants were alleged to be engaged in a common plan or concert of action which was characterized as a conspiracy; in *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959), the defendant knew that the securities in question would be sold without registration; in *H.L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960), the defendant accountants knowingly prepared false financial statements with an intent to induce the plaintiff to enter into a merger; in *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963), the trustees alleged that the bank, the brokerage firm, and the exchange knowingly participated in supporting defendants' illegal activities; in *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), at the time each insider defendant offered to buy the plaintiffs' shares he knew of a proposed public and private offering at a higher price; in *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968), knowing assistance in a fraudulent scheme was alleged; in *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), the bank was alleged to have given active and knowing assistance to the primary wrongdoers; in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969), the defendant was alleged to have knowingly aided, abetted, and assisted a bankrupt in using fraudulently converted property. In *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), the court did not discuss whether knowledge was a requirement. Instead, it emphasized its duty to determine whether the trial judge's decision that Midwestern officials knew Dobich was misusing his customers' money could be sustained. *Id.* at 151.

will be required to investigate the ultimate activities of the party whom he is assisting, a burden may be imposed upon business activities that is too great. Although such a duty might contribute to the protection of investors by creating another level of private investigators, creation of such a duty through use of aiding and abetting or conspiracy concepts should take place only through the sound foundations of judicial precedent in analogous fields or express statutory language.

The essential point is that imposition of a duty to investigate under the guise of a "should have known" standard in essence would amount to eliminating scienter as a necessary element in imposing aiding and abetting liability and the substitution of a negligence standard. The existence of a scienter standard rather than a negligence standard seems clear in criminal cases dealing with conspiracy and aiding and abetting. In conspiracy there must be an intent to do wrong. As one court put it:

[I]t must appear that the defendant knew of the illegal element involved in that which the combination was intended to accomplish. . . . To constitute the criminal intent necessary to establish a conspiracy there must be both knowledge of the existence of the law and knowledge of its actual or intended violation.¹⁵⁶

Knowledge of wrongful purpose is also a necessary element in criminal law aiding and abetting cases. In a still cited California forgery case, the court held invalid an instruction that would have allowed conviction for aiding *or* abetting. It stated:

A person may aid in the commission of an offense by doing innocently some act essential to its accomplishment, and this is especially true in regard to the crime of forgery, for he may pass the forged instrument without knowing that it is forged. The word "aid" does not imply guilty knowledge or felonious intent, whereas the definition of the word "abet" includes knowledge of the wrongful purpose of the perpetrator and counsel and encouragement in the crime.¹⁵⁷

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¹⁵⁶ Commonwealth v. Benesch, 290 Mass. 125, 135, 194 N.E. 905, 910 (1935), quoted in W. CLARK & W. MARSHALL, LAW OF CRIMES § 9.02 (7th ed., M. Barnes ed. 1967).

¹⁵⁷ People v. Dole, 122 Cal. 486, 492, 55 P. 581, 584 (1898); see People v. Etie, 119 Cal. App. 2d 23, 258 P.2d 1069 (1953); State v. Corcoran, 7 Idaho 220, 61 P. 1034 (1900); State v. Allen, 34 Mont. 403, 87 P. 177 (1906). Similar concepts appear in a series of Supreme Court cases dealing with conspiracy and aiding and abetting: United States v. Falcone, 311 U.S. 205, 210-11 (1940) (citations omitted):

The gist of the offense of conspiracy . . . is agreement among the conspirators to commit an offense attended by an act of one or more of the conspirators to effect the object of the conspiracy. . . . Those having no knowledge of the conspiracy are not conspirators . . . and one who without more furnishes supplies to an illicit distiller is not guilty of conspiracy even though his sale may have furthered the object of a conspiracy to which the distiller was a party but of which the supplier had no knowledge.

A statement that the actor must not only know what the primary participants plan, but that he must have an awareness of the illegality of their proposed acts appears in a narcotics case holding that the jury must find that "the defendants charged with conspiracy had *knowledge* of the general illicit purposes of importation, transportation, or adulteration."¹⁵⁸ In dismissing a civil case alleging fraudulent conduct under rule 10b-5, a district court judge recently stated:¹⁵⁹

"Conspiracy involves an element of scienter." . . . Such guilty knowledge of or participation in a concerted, pre-arranged unlawful plan has not been demonstrated. Nor is one party's domination of persons and corporations a sufficient predicate for finding a conspiracy existed.¹⁶⁰

Agreement that a knowledge requirement exists and that the knowledge must include knowledge of the illegality of the act in question does not complete the knowledge analysis. Given the difficulty of probing a man's mind, courts have confronted knowledge requirements in several ways.

In cases in which courts desire to impose liability but are unsure regarding their ability to justify results on a factual basis, they may resort to discussion of knowledge in terms of recklessness. Thus in *Trussel v. United Underwriters, Ltd.*,¹⁶¹ the court analyzed the various subsections of rule 10b-5, compared them to the provisions of section 12(2) of the 1933 Act,¹⁶² and concluded that scienter was a necessary element in a rule 10b-5 action. Nevertheless, it added that the scienter requirement could be satisfied by a showing of recklessness:

Direct Sales Co. v. United States, 319 U.S. 703, 711 (1943) (dealing with sale of narcotics) (footnote omitted):

This intent, when given effect by overt act, is the gist of conspiracy. While it is not identical with mere knowledge that another purposes unlawful action, it is not unrelated to such knowledge. Without the knowledge, the intent cannot exist. *United States v. Falcone*, *supra*. Furthermore, to establish the intent, the evidence of knowledge must be clear, not equivocal. *Ibid*. This, because charges of conspiracy are not to be made out by piling inference upon inference, thus fashioning what, in that case, was called a dragnet to draw in all substantive crimes.

Nye & Nissen v. United States, 336 U.S. 613, 620 (1949):

Aiding and abetting has a broader application [than conspiracy]. It makes a defendant a principal when he consciously shares in any criminal act whether or not there is a conspiracy.

¹⁵⁸ *United States v. Agueci*, 310 F.2d 817, 825 (2d Cir. 1962), *cert. denied*, 372 U.S. 959 (1963) (emphasis in original).

¹⁵⁹ *Dasho v. Susquehanna Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,575 (N.D. Ill. 1970), *aff'd in part & rev'd in part*, CCH FED. SEC. L. REP. ¶ 93,342 (7th Cir. 1972).

¹⁶⁰ *Id.* at 98,623.

¹⁶¹ 228 F. Supp. 757 (D. Colo. 1964).

¹⁶² *Id.* at 762-72.

We do not understand, however, that a knowing or intentional violation of Rule 10b-5(2) must necessarily involve actual knowledge. Even in common-law fraud actions in Colorado, for example, it is clear that a representation made in reckless disregard of its truth or falsity is legally equivalent to a representation made with actual knowledge of its falsity.¹⁶³

A similar result was reached in a recent SEC action in which the Second Circuit applied a recklessness standard to conduct which could be described either as primary participation or aiding and abetting.¹⁶⁴

The *Trussel* court also approached the knowledge requirement by indicating that knowledge could be proved by inference. It found that "[f]rom the totality of events a scheme to defraud may be deduced."¹⁶⁵ Similarly, in the *Brennan* case the Seventh Circuit majority opinion stated:

Our function is to ascertain, after considering the record in its entirety, whether the inferences drawn by the trial judge have a sufficient evidentiary basis so that it can be said they are reasonable, that is, could have been arrived at by logical deduction.¹⁶⁶

Often a court or jury will not have direct evidence regarding knowledge and will be required to reach a conclusion through inference.¹⁶⁷ In an aider and abettor case not in the securities field,

¹⁶³ *Id.* at 772.

¹⁶⁴ SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 72, 80, 81 (2d Cir. 1970). In one phase of the case the court used aiding and abetting language, but did not discuss a scienter requirement. In another phase of the case the court used recklessness language, but did not indicate that it was employing aiding and abetting concepts.

¹⁶⁵ 228 F. Supp. at 772.

¹⁶⁶ 417 F.2d at 149. The dissenting judge objected to the result on the grounds that the trial judge's decision "rests on a compounding of wholly unjustified inferences and upon pure speculation." *Id.* at 156. He stated "there is simply nothing to suggest more than a highly speculative possibility that defendant could have any knowledge of any fraud, much less that it engaged in any intentional aiding or abetting thereof." *Id.*

¹⁶⁷ The following are illustrative statements. *Peterson v. Cruickshank*, 144 Cal. App. 2d 148, 163, 300 P.2d 915, 925 (1956):

In fact, in the absence of a confession by one of the conspirators, it is usually very difficult to secure direct evidence of a conspiracy, so that in the usual case the ultimate fact of a conspiracy must be determined from those inferences naturally and properly to be drawn from those matters directly proved.

Galatas v. United States, 80 F.2d 15, 22 (8th Cir. 1935), *cert. denied*, 297 U.S. 711 (1936):

Conspiracy is rarely susceptible of direct and positive proof, but it may be proven by circumstantial evidence.

Lawlor v. National Screen Serv. Corp., 99 F. Supp. 180, 187 (E.D. Pa. 1951), *rev'd on other grounds*, 238 F.2d 59 (3d Cir. 1956), *vacated & remanded*, 352 U.S. 992 (1957):

The essence of conspiracy, in the absence of actual agreement, is scienter by the conspirators: a mutual awareness of each other's activities, a contemplated

Costello v. United States,¹⁶⁸ the Eighth Circuit compared the proof problem to that in cases involving receipt of stolen goods:

The requisite guilty knowledge need not be actual, direct, positive, or absolute, but may be constructive, implied, or circumstantial. It is not essential to a conviction that the requisite guilty knowledge that the goods were stolen should be actual, direct or positive and absolute, such, for instance, as knowledge acquired by having personally witnessed or observed the theft, or by information of the theft from persons who had personal knowledge, such as eye witnesses or the person from whom the goods were received; the requisite knowledge may be circumstantial or deductive, and constructive or implied knowledge through notice of facts and circumstances from which guilty knowledge may be fairly inferred satisfies the requirements as to knowledge.¹⁶⁹

Application of the knowledge requirement in securities law conspiracy or aiding and abetting cases could be confused by the requirement in section 32(a) of the 1934 Act¹⁷⁰ and section 24 of the 1933 Act¹⁷¹ that anyone who "willfully" violates the act in question will suffer criminal penalties.¹⁷² It is essential to distinguish between the requirement that in order for a violation of the Securities Acts to be criminal it must be "willful" and the requirement that in order for aiding and abetting and conspiracy to be actionable the conduct must be knowing or reckless. According to one commentator, the word "willfully" has been construed, in criminal and disciplinary cases, in accordance with the SEC view that "the term does not require proof of evil motive, or intent to violate the law, or knowledge that the law was being violated."¹⁷³ A frequently used definition is the following:

It is only in very few criminal cases that "willful" means "done with a bad purpose." Generally, it means "no more

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concert of action. There may be circumstances in which mutual knowledge should be inferred in the absence of specific proof.

Gusow v. United States, 347 F.2d 755, 759-60 (10th Cir.), *cert. denied*, 382 U.S. 906 (1965) (mail fraud case requiring "proof of intentional devising of a scheme to defraud"):

Fraud or the existence of a fraudulent scheme is seldom susceptible to proof solely by direct evidence and in nearly every such case, direct and circumstantial evidence together with the inferences to be drawn therefrom must be relied upon for proof.

(quoting from *Beck v. United States*, 305 F.2d 595, 598 (10th Cir.), *cert. denied*, 371 U.S. 890 (1962)).

¹⁶⁸ 255 F.2d 389 (8th Cir.), *cert. denied*, 358 U.S. 830 (1958).

¹⁶⁹ *Id.* at 400 (quoting from 76 C.J.S. *Receiving Stolen Goods* § 8 (1952)).

¹⁷⁰ 15 U.S.C. § 78ff (1970).

¹⁷¹ *Id.* § 77x.

¹⁷² As Professor Loss points out, the word "willful" is one which "is construed at least as diversely as it is spelled." 2 L. LOSS, *SECURITIES REGULATION* 1309 (2d ed. 1961).

¹⁷³ 5 L. LOSS, *SECURITIES REGULATION* 3368 (Supp. 1969) (footnote omitted).

than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law.”¹⁷⁴

That definition should not be accepted as the definition of the knowledge requirement in conspiracy and aiding and abetting cases because it deals only with satisfaction of the willfulness requirement.

The confusion between “willfulness” and “knowledge of illegal activities” is illustrated in *United States v. Benjamin*.¹⁷⁵ That case involved a financial fraud perpetrated by Mende, the principal promoter, Benjamin, his lawyer, and Howard, a certified public accountant. The court dealt with a conspiracy claim and objections by Howard and Benjamin as to the sufficiency of the evidence. Although the court found that both defendants had actual knowledge of the false assertions,¹⁷⁶ it defined the word “willful” in a manner that implied that satisfaction of that definition would satisfy the “knowledge” requirement. It stated:

We think that in the context of § 24 of the Securities Act [the criminal section containing the willful requirement] as applied to § 17(a), the Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant.¹⁷⁷

The danger in equating the two requirements is that the knowledge requirement for conspiracy and aiding and abetting liability could be reduced to a mere showing that the secondary party knew what he was doing rather than a showing that he knew of the illegal plan or conduct.

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¹⁷⁴ *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949) (quoting from *Dennis v. United States*, 171 F.2d 986, 990 (D.C. Cir. 1948), *aff'd*, 339 U.S. 162 (1950), which in turn quoted from *Townsend v. United States*, 95 F.2d 352, 358 (D.C. Cir.), *cert. denied*, 303 U.S. 664 (1938)), quoted in 5 L. Loss, *SECURITIES REGULATION* 3368 (Supp. 1969). Professor Loss questions whether this definition will stand review by the Supreme Court, citing *Morissette v. United States*, 342 U.S. 246, 250 (1952). 5 L. Loss, *SECURITIES REGULATION* 3367-68 (Supp. 1969). More significantly, he correctly distinguishes between the “willfulness” requirement of the Securities Acts and the “knowledge” or “intent” requirement of the conspiracy or aiding and abetting cases. Commenting on the decision in *United States v. Crosby*, 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962), Professor Loss states that “intent is an element of the offense” in a conspiracy case. 5 L. Loss, *SECURITIES REGULATION* 3369-70 (Supp. 1969).

¹⁷⁵ 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

¹⁷⁶ *Id.* at 862 (Howard), 863 (Benjamin).

¹⁷⁷ *Id.* at 862, citing cases. The court continued by stating “[o]ther circuits have gone further and have held the willfulness requirement of the Securities Acts to be satisfied in fraud cases by proof of representations which due diligence would have shown to be untrue.” *Id.* at 863. The cited cases, however, *Stone v. United States*, 113 F.2d 70, 72-74 (6th Cir. 1940), and *United States v. Schaefer*, 299 F.2d 625, 628-29 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962), involved circumstances that can be described as reckless rather than negligent conduct.

A different and more enlightened approach to a similar problem was taken by the Second Circuit in *United States v. Crosby*.¹⁷⁸ There the court reversed criminal convictions against brokers alleged to have participated in a conspiracy to sell unregistered stock. The court found that the government had failed to present any proof that the brokers knew that the unregistered stock they were dealing with was not exempt from the registration requirements.¹⁷⁹ The *Crosby* case correctly requires close scrutiny of the acts and state of mind of each individual defendant.

In a ruling on a motion to transfer, one lower court has stated the knowledge requirement as follows:

While there is no tort in civil law which may be described as "aiding and abetting," allegations alleging joint and concerted actions, knowingly committed with knowledge of a purpose accomplishing an alleged wrong are sufficient to sustain a claim as a joint tortfeasor.¹⁸⁰

Emphasis upon knowledge of the unlawful purpose of the primary wrongdoer, whether proved directly or by inference, should be heeded by other courts.

To summarize, knowledge of the primary illegal course of conduct should be required for aiding and abetting or conspiracy liability. Deviation from this requirement would unreasonably impose liability on secondary defendants. Adherence to the knowledge requirement still allows imposition of liability in appropriate cases, since knowledge can be shown by reckless conduct or through inference. The knowledge requirement should not be confused with the less demanding "willfulness" requirement used in the 1933 and 1934 Acts. Finally, it should be noted that although the good faith defenses in the controlling persons sections will probably not be applicable to judicially construed secondary liability theory, the knowledge requirement under conspiracy and aiding and abetting theories effectively reintroduces the "good faith" defense of those sections.

4. The Conspiracy Approach

In the framework of the present analysis, once it has been established that an independent wrong exists and that the defendant knows

¹⁷⁸ 294 F.2d 928 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962).

¹⁷⁹ *Id.* at 942. *See also* *United States v. Dardi*, 330 F.2d 316 (2d Cir.), *cert. denied*, 379 U.S. 845 (1964).

¹⁸⁰ *Wyndham Associates v. Bintliff*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶92,016, at 96,457 (S.D.N.Y. 1967), *aff'd*, 398 F.2d 614 (2d Cir.), *cert. denied*, 393 U.S. 977 (1968). This is one of the Westec cases. *See* note 5 *supra*.

of that wrong and its illegality, it will still be necessary to establish in an aiding and abetting case that he gave substantial assistance to the person engaged in the conduct, and in a conspiracy case that the defendant agreed to join in the unlawful conduct.

As will be noted below, securities cases have not distinguished clearly between charges that the secondary defendant "aided and abetted" another person in achieving an unlawful result, and charges that a secondary defendant "conspired" to help another accomplish that unlawful result.¹⁸¹ The word "conspiracy" has been used expansively in some cases to describe conduct more closely resembling aiding and abetting. For instance, in *H. L. Greene Co. v. Childree*,¹⁸² the court refused to dismiss a complaint against accountants "who, according to the complaint, knowingly prepared false financial statements and made other misrepresentations with intent to induce [a corporation] to enter into [a] merger."¹⁸³ It held that the defendants would be subject to liability if they "knowingly did acts pursuant to a conspiracy to defraud."¹⁸⁴ In a recent case, *SEC v. National Bankers Life Insurance Co.*,¹⁸⁵ the court observed that the SEC had sought to hold all defendants liable for joint participation in a "scheme to defraud" under subsection (1) of rule 10b-5 "on the basis that 'scheme' as used in that subsection is synonymous with conspiracy."¹⁸⁶ The court stated that even in the absence of statutory reference to a scheme or conspiracy, a plaintiff "can allege a conspiracy" to violate the securities law.¹⁸⁷

If conspiracy to violate the securities laws is used as the basis for a private right of action, courts should more carefully define the conspiracy concept. For such a purpose a whole series of inquiries becomes relevant:¹⁸⁸

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¹⁸¹ Text accompanying notes 188-93 *infra*.

¹⁸² 185 F. Supp. 95 (S.D.N.Y. 1960).

¹⁸³ *Id.* at 96.

¹⁸⁴ *Id.*

¹⁸⁵ 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

¹⁸⁶ *Id.* at 195.

¹⁸⁷ *Id.* The court also held that knowledge was a requirement. It characterized the knowledge requirement as follows:

The knowledge requirement for liability under such a scheme is more than that required to hold someone as an aider and abettor to a single sale of unregistered stock or a single fraudulent act and probably something comparable to that required to hold a person liable as an aider and abettor to a scheme to defraud—general awareness of overall improper conduct and that the act performed in some way contributes to that conduct.

Id.

¹⁸⁸ The following comments are derived in part from Brenner, *Selected Jury Instruction Forms in an SEC Criminal Case*, 41 F.R.D. 93, 121-27 (1966).

(1) Did an agreement exist to commit a violation of federal securities law?

(2) Did the defendant know that the purpose of the agreement was criminal?

(3) Did the defendant participate in the conspiracy, have knowledge of its illegal purpose, and intend to aid in the accomplishment of its illegal ends?

(4) Did one of the conspirators carry out an overt act in furtherance of the conspiracy?

(5) Was the overt act committed by a party to the alleged conspiracy after an illegal understanding had been reached? Did it tend toward accomplishment of the intended illegal act of the conspiracy, and did the person performing the act know and intend that it be such a step?

(6) Was there a single continuing overall conspiracy or were there several independent conspiracies requiring individual proof?

(7) Was evidence of participation in the conspiracy drawn from conduct or statements of the defendant rather than conduct or statements of other defendants or co-conspirators made in his absence?

The above questions are frequently asked in criminal conspiracy prosecutions involving securities law fraud. They have not been asked in the reported cases dealing with civil liability. Although proof of the necessary agreement, the necessary overt act, and other elements of a criminal conspiracy presumably would be required to show the existence of a conspiracy to violate the securities laws, the cases stating that such a private right of action exists¹⁸⁹ do so without analysis. Attempts at clarity are further confused when courts express their willingness to combine conspiracy and aiding and abetting as a single wrong. For instance, in *SEC v. National Bankers Life Insurance Co.*¹⁹⁰ the court dealt with a complaint by the SEC, which it described as employing a "conspiracy theory" in the first count and "a joint scheme theory which is comparable to conspiracy" in the second count.¹⁹¹ The court treated the language of subsection (1) of rule 10b-5 as permitting an action to be brought upon the basis of participation in "a scheme to

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¹⁸⁹ *E.g.*, *H.L. Green Co. v. Childree*, 185 F. Supp. 95, 96 (S.D.N.Y. 1960). *But see* *Bryant v. Donnell*, 239 F. Supp. 681, 687-88 (W.D. Tenn. 1965) (the federal conspiracy statute does not support a private right of action).

¹⁹⁰ 324 F. Supp. 189 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

¹⁹¹ *Id.* at 194.

defraud.”¹⁹² It characterized the word “scheme” as being synonymous with “conspiracy,” but, apparently not satisfied with this approach, noted that:

For the purposes of this case, we will assume that the SEC intended to allege that peripheral defendants were aiders and abettors to a scheme or plan under subsection (1) and in this sense were co-schemers.¹⁹³

This attempt to connect conspiracy to aiding and abetting demonstrates the confusion that can be created by using conspiracy doctrine. What the *National Bankers Life* court might have said was the following:

(1) A defendant may be subject to liability for violating the securities laws.

(2) He may be subject to liability for conspiring or scheming with another to violate the securities laws.

(3) He may be subject to liability for aiding and abetting a violation of the securities laws.

(4) He may be subject to liability for aiding and abetting a conspiracy or scheme to violate the securities laws.

Such an approach would preserve the dichotomy between conspiracy and aiding and abetting, by recognizing the necessity of proving agreement in order to prove conspiracy and the necessity of proving the existence of an act when proving aiding and abetting. It would not, however, avoid the difficult conspiracy law questions posed above.

5. The Active-Passive Distinction in Aiding and Abetting Cases

Perhaps because courts realize that conspiracy theory is hard to apply, the securities law cases that have contained substantial analysis have tended to use aider and abettor language.¹⁹⁴ The use of the aiding and abetting theory may nevertheless achieve a result similar to conspiracy to the extent that liability can be based upon inaction. The best support for an inaction theory appears in the lower court decision

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¹⁹² *Id.* at 195.

¹⁹³ *Id.* It also attempted to distinguish between the knowledge requirement applicable to an aider and abettor of a single act and the knowledge requirement applicable to an aider and abettor of a fraudulent scheme.

¹⁹⁴ The SEC has made frequent use of the doctrine. See text accompanying notes 114-22 *supra*.

in the *Brennan* case,¹⁹⁵ cited by the court in *SEC v. National Bankers Life Insurance Co.* for the proposition that "a person may be held as an aider and abettor through either an act or an omission."¹⁹⁶ Significantly, although the Seventh Circuit in the *Brennan* case¹⁹⁷ had before it a decision of the district court that Midwestern was subject to liability for failing to take action, it did not hold that inaction alone was sufficient to sustain liability. The district court had held that by its failure to report Dobich's activities to the SEC or to the Indiana Securities Commission, Midwestern had "knowingly and purposefully encouraged an artificial build-up in the market for its stock . . . ." ¹⁹⁸ The Seventh Circuit stated:

It is our view that the district court was correct in concluding that Midwestern's acquiescence through silence in the fraudulent conduct of Dobich combined with its affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and Rule 10b-5.¹⁹⁹

It added that it reached its conclusion "[w]ithout deciding whether the failure to report Dobich's activities to the Indiana Securities Commission would in itself give rise to liability under Rule 10b-5 . . . ." ²⁰⁰ Thus the question of whether inaction might cause liability was specifically left open.

In *Wessel v. Buhler*,²⁰¹ the Ninth Circuit was faced with a contention that a certified public accountant owed a duty to prospective investors to disclose his knowledge of a corporation's irregular financial conduct and of deficiencies in its financial records and by failing to perform that duty he aided and abetted the principal wrongdoer. The court rejected this contention:

We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction. On the contrary, the only subsection that has any reference to an omission, as distinguished from affirmative action, is subsection (2) providing that it is unlawful "to omit to state a material fact necessary in order to make the statements made . . . not misleading," *i.e.*, an omission occurring as part of an affirmative statement. . . . We perceive no reason, con-

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¹⁹⁵ 259 F. Supp. 673 (N.D. Ind. 1966), 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

¹⁹⁶ 324 F. Supp. at 195.

¹⁹⁷ 417 F.2d 147.

¹⁹⁸ *Id.* at 154. The language is the Seventh Circuit's characterization of the district court's holding.

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 155.

²⁰¹ 437 F.2d 279 (9th Cir. 1971).

sonant with the congressional purpose in enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5 liability. . . . On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and counsel, would lead to serious mischief.²⁰²

The *Wessel* and *Brennan* cases, when read together, may help resolve the question whether and under what circumstances a court should impose liability for mere inaction. In its first opinion in the *Brennan* case,²⁰³ the district court dealt with a contention by the defendant that "aiding, abetting, and giving assistance or encouragement necessarily requires an affirmative act" and that *Midwestern's* silence would not make it liable for damages caused by *Dobich's* wrongdoing.²⁰⁴ The court rejected what it termed "abstract and mechanical distinctions between active and passive assistance," refusing "to hold blindly that silence and inaction cannot constitute aiding and abetting under any possible set of circumstances . . . ." ²⁰⁵ Instead, it indicated that a defendant may be liable for aiding and abetting based upon silence and inaction in those circumstances in which it has a duty to act. Although it did not state what those duties might be, it was willing to accept the possibility that a corporation's duties to its shareholders might include the duty to inform them that a fraud in connection with its stock was underway. The court also suggested the possibility that insiders and others owing independent fiduciary duties might have an obligation to make affirmative disclosures.²⁰⁶

Similarly, in the *Wessel* case, the court was faced with a separate contention that the defendant *Jordan* owed an obligation to prospective investors to disclose knowledge concerning financial statements he knew were inaccurate.²⁰⁷ The theory advanced there can be reconciled with the lower court's opinion in the *Brennan* case to the extent that circumstances might exist in which an accountant would owe an independent duty to investors to make disclosures regarding financial information known to him. In such a case, however, the duty to disclose information about wrongdoing exists independently, and the violation of the federal securities laws rests upon an independent duty rather than upon an aiding and abetting theory. As noted earlier, cases dealing with accountants' liability, such as *Fischer v. Kletz*,²⁰⁸ rest upon the theory

²⁰² *Id.* at 283.

²⁰³ 259 F. Supp. 673 (N.D. Ind. 1966).

²⁰⁴ *Id.* at 681.

²⁰⁵ *Id.* at 682.

²⁰⁶ *Id.* at 681.

²⁰⁷ 437 F.2d at 283.

²⁰⁸ 249 F. Supp. 539 (S.D.N.Y. 1966), 266 F. Supp. 180 (S.D.N.Y. 1967); see notes 74-88 *supra* & accompanying text.

that there exists an independent duty to the injured party. Thus in *Fischer* the court acknowledged possible liability for accountants who know that their previously filed financial statements relied upon by the public are no longer accurate.²⁰⁹ So too, in *Hecht v. Harris Upham & Co.*,²¹⁰ the court was willing to impose liability upon the New York partners of a brokerage firm for their failure to supervise an employee in the San Francisco office under circumstances in which they had reason to know that he was engaged in illegal churning activities. In *Fischer* and *Hecht* the liability would be primary, not secondary.

On its facts, *Wessel v. Buhler* seems to be correctly decided because the figures being used were not those that had been prepared by Jordan, the accountant. Rather, it was alleged that after Jordan prepared correct financial figures, those figures were altered and used in their altered form by the primary wrongdoers. Since Jordan had not certified the figures actually used, he had no independent duty to warn of their inaccuracy.

The above analysis points to the conclusion that "mere inaction" should not give rise to liability under rule 10b-5 in the absence of an independent duty to make disclosure of the primary wrong. If such a duty does exist, liability for nondisclosure will be based upon direct breach of a duty to disclose rather than upon an aiding and abetting theory.²¹¹

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²⁰⁹ 266 F. Supp. at 188.

²¹⁰ 283 F. Supp. 417 (N.D. Cal. 1968), *modified & aff'd*, 430 F.2d 1202 (9th Cir. 1970).

²¹¹ Additional support for the conclusion that positive assistance is necessary for aiding and abetting liability in the absence of an independent duty to take action appears through examination of the factual circumstances in which liability has been imposed. The following cases are illustrative.

In *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex. 1971), all of the defendants were alleged to have purchased, sold, or pledged stock or to have loaned money in knowing assistance of a fraudulent scheme to sell unregistered securities and to manipulate securities markets.

In *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), the Seventh Circuit held that Midwestern affirmatively assisted Dobich in defrauding his brokerage customers by referring directly to him the complaints of dissatisfied customers who might otherwise have filed charges before the Securities and Exchange Commission or the Indiana Securities Commission. *Id.* at 154.

In *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970), those defendants characterized as aiders and abettors helped to prepare reports, aided in selling efforts, and otherwise helped to promote sale of unregistered stock through false and misleading statements.

In *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963), the brokerage company defendant and several banks were accused of permitting Lowell Birrell to open and maintain dummy accounts in order to conceal his manipulative activities about which they had knowledge, while the American Stock Exchange specialists were charged with knowingly participating in illegal stock distributions. *Id.* at 28.

In *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968), the defendant brokerage firms were alleged to have aided and abetted the primary wrongdoer by allowing him to use their office facilities and market materials, by supporting statements that he was solvent, by endorsing his skill and standing as a commodities trader, and by holding him out as a favored and valued customer. *Id.* at 709.

F. Policy Considerations

One conclusion of this Article is that the liability of many defendants who might otherwise be called secondary defendants will in fact be primary, because of direct obligations owed by those defendants. The defendant may, for instance, owe a duty as an accountant or a stockbroker, or he may be a corporate insider owing special duties by reason of that relationship.²¹² The defendant may be a stock exchange or an association of securities dealers owing independent duties.²¹³

In the absence of such duties and in the absence of direct participation in the wrongdoing, liability will depend upon application of "secondary liability" concepts. The defendant may be subject to liability as a controlling person of a wrongdoer under express securities law provisions.²¹⁴ He may be liable under aspects of common law agency theory. Where a defendant knows that a securities law fraud is underway and lends his assistance to it, he may be subject to liability under aiding and abetting or conspiracy doctrines. This Article has suggested that liability does not attach under the latter doctrines in the absence of knowledge by the defendant. Likewise, it has been suggested that liability under aiding and abetting theories does not attach if the defendant merely fails to take action.

These conclusions are consistent with the policies underlying securities regulation. Those defendants who have participated directly in a securities law fraud will be subject to liability if their conduct satisfies the elements required for proof of direct violation. The primary wrongdoer will not escape liability. Additionally, those who have a separate obligation to the public to take steps to prevent injury will be subject to liability. Thus brokerage firms and stock exchanges may be subject to liability for breach of their duty to supervise. Professionals, such as

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In *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949), the defendant Merrill, Lynch assisted a correspondent dealer by encouraging him to state to the SEC that he carried on his business in segregated accounts through Merrill, Lynch rather than in omnibus accounts. *Id.* at 122-23.

²¹² Cf. *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), *aff'd* 208 F. Supp. 808 (E.D. Wis. 1962).

²¹³ See *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963). Regarding liability for violation of stock exchange rules, see *Hoblin, A Stock Broker's Implied Liability to Its Customer for Violation of a Rule of a Registered Stock Exchange*, 39 *FORDHAM L. REV.* 253 (1970); *Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules*, 66 *COLUM. L. REV.* 12 (1966); *Lowenfels, Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 *CORNELL L.Q.* 633 (1966); *MacLean, Brokers' Liability for Violation of Exchange and NASD Rules*, 47 *DENV. L.J.* 63 (1970); Note, *Federal Margin Requirements as a Basis for Civil Liability*, 66 *COLUM. L. REV.* 1462 (1966); Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 *HARV. L. REV.* 825 (1970); Comment, *Civil Remedies and Stock Exchange Rules—An Emerging Concept of Implied Liability*, 1969 *U. ILL. L.F.* 551.

²¹⁴ Under § 15 of the 1933 Act, 15 U.S.C. § 77o (1970), and § 20 of the 1934 Act, 15 U.S.C. § 78t (1970).

accountants and brokers, will have special duties arising out of their relationships with the public. For instance, brokers may sustain liability for churning accounts,²¹⁵ making unsuitable recommendations,²¹⁶ or failing to have a reasonable basis for making recommendations.²¹⁷ Accountants may be subject to liability for preparing misleading financial statements they know will be used by lenders and investors.²¹⁸ Finally, those persons who are not primary wrongdoers and do not fall within the special purviews of agency doctrines or the controlling persons provisions will be subject to liability when they know of the existence of a securities law fraud and either enter into an agreement with or give assistance to the primary wrongdoer.

Imposition of liability upon secondary defendants under aiding and abetting or conspiracy theories as narrowly defined here can be justified because of the culpable nature of their conduct. Such individuals will be subject to liability because they have acted knowingly or recklessly to assist fraudulent conduct or have agreed to be a part of a fraudulent scheme. On the other hand, to impose liability upon those who merely know of fraudulent conduct but have no separate duty to act or upon those who assist in fraudulent conduct without knowing that the conduct is unlawful would unfairly extend liability to many persons whose primary businesses are unrelated to the securities markets. Imposition of liability upon lenders, financial printers, newspapers, landlords, creditors, suppliers, minor employees, and others in such circumstances would impose liability where the degree of fault is relatively minor.

II. CONTRIBUTION, INDEMNIFICATION, AND *In Pari Delicto*

The policy rationale offered in part I of this Article relies to a large degree upon the belief that securities law policy includes both protection of investors and fairness toward defendants.²¹⁹ One aspect of this fairness doctrine involves finding dividing lines based upon the duty owed by the defendant, his knowledge, and his assistance in the illegal scheme. If the defendant's duty is dependent upon his status within the securities industry,²²⁰ liability may be imposed upon him when liability

²¹⁵ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *modified & aff'd*, 430 F.2d 1202 (9th Cir. 1970).

²¹⁶ *See Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969) (not a private action); *Avern Trust v. Clarke*, 415 F.2d 1238 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970) (private recovery may be based on NASD rules) (dictum).

²¹⁷ *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

²¹⁸ *See* text accompanying notes 64-98 *supra*.

²¹⁹ The fairness concept has been advanced in another context in *Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423 (1968).

²²⁰ For example, an exchange, broker-dealer, accountant, or corporate fiduciary.

would not be imposed upon persons unconnected with the industry. Where securities law liability exists because of activities that amount to fraud²²¹ independent of special status, such liability should rest primarily upon the defendant's fault. This fault analysis should apply consistently even though the defendant may be either a primary or a secondary wrongdoer.

Not only are fault principles important in determining whether liability should exist at all, but they can be used to adjust burdens among multiple defendants. If a court is able to distinguish between the degrees of fault of the various parties when it imposes liability, it should be able to utilize such distinctions in determining how liabilities should be divided. This portion of the Article will consider problems of allocating liability in multiple defendant cases.

A. Contribution and Indemnification Distinguished

Assuming that many defendants are sued in the same action, a defendant looking for relief from all or part of his liability may assert doctrines of contribution and indemnification against other defendants. The two doctrines should be carefully distinguished. Contribution involves distributing losses among tortfeasors by requiring each to pay his proportionate share. Indemnity entails shifting the entire loss from one tortfeasor who has been compelled to pay it to another who, for equitable reasons, should bear it instead.²²² In essence, contribution results in a sharing of the burden, whereas indemnity results in shifting it.

B. Contribution

Courts have had little difficulty in enforcing the right of contribution where a contractual relationship gives rise to the parties' liability.²²³ The more troublesome situation arises when a suit for contribution is between joint or concurrent wrongdoers. The premise of a suit for contribution by one wrongdoer against another is that the parties are jointly responsible for the harm and therefore should share

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²²¹ Such as outright misrepresentations or stock manipulation.

²²² W. PROSSER, *LAW OF TORTS* 310 (4th ed. 1971) (paraphrased) (citing *McFall v. Compagnie Maritime Belge (Lloyd Royal) S.A.*, 304 N.Y. 314, 107 N.E.2d 463 (1952)); see *Hendrickson v. Minnesota Power & Light Co.*, 258 Minn. 368, 370-71, 104 N.W.2d 843, 846-47 (1960).

²²³ The most common illustration involves the rights of sureties who have paid the obligation of their principal where there is more than one surety. Leflar, *Contribution and Indemnity Between Tortfeasors*, 81 U. PA. L. REV. 130, 135 (1932).

the burden of the liability. Under English common law, contribution usually was permitted only in favor of non-intentional wrongdoers.²²⁴ In general, it was said that the law will imply a promise for contribution except where the wrongdoing was intentional. In 1898 one commentator stated:

As between conscious, wilful, malicious, or intentional joint wrong-doers, or tort-feasors who are *in pari delicto*, neither the law nor equity will intervene to adjust the damage by enforcing contribution.²²⁵

The early American courts, however, soon lost sight of the intentional, non-intentional distinction and established the general rule that there is to be no contribution between concurrent wrongdoers of any kind.²²⁶

Only a handful of American jurisdictions have *judicially* overruled this no-contribution rule. These have returned to the intentional, non-

²²⁴ For an excellent analysis of the development of the right of contribution, see Reath, *Contribution Between Persons Jointly Charged for Negligence—Merryweather v. Nixan*, 12 HARV. L. REV. 176 (1898). Other treatments of contribution include Hodges, *Contribution and Indemnity Among Tortfeasors*, 26 TEXAS L. REV. 150 (1947) (more important for its discussion of the right to indemnity); Jones, *Contribution Among Tortfeasors*, 11 U. FLA. L. REV. 175 (1958) (opposing adoption of a doctrine of contribution in Florida without close legal analysis); Leflar, *supra* note 223; Note, *Aspects of the Right of Contribution Among Tortfeasors*, 33 TEMP. L.Q. 432 (1960) (discussing the Uniform Contribution Among Tortfeasors Act); Comment, *Contribution and Indemnity Among Joint Tortfeasors*, 33 TENN. L. REV. 184 (1966); Note, *The Right of Contribution as Extended to Negligent Tortfeasors*, 76 U. PA. L. REV. 979 (1928); Comment, *Contribution Among Joint Tortfeasors*, 1960 WIS. L. REV. 478. The important cases in the development of the doctrines of contribution and indemnity are mostly early ones. As a result, there is an unusual consistency in the citations from the early writings to the more recent ones.

²²⁵ Reath, *supra* note 224 (entire quotation in original in italics). Unfavorable treatment of intentional wrongdoers appeared at least as early as 1623 in *Batterseys Case*, 124 Eng. Rep. 41 (C.P. 1623). Other well-known early cases that reinforce the distinction between intentional and non-intentional wrongdoers are *Everet v. Williams*, 9 L.Q. REV. 197 (1893) (Ex. 1725), perhaps better known as the *Highwayman's Case*, and *Merryweather v. Nixan*, 101 Eng. Rep. 1337 (K.B. 1799). *Merryweather* is perhaps the most often cited case in discussions of the growth of the right to contribution at common law. Although usually cited as stating the rule, it states the exception. Faced with facts involving a claim for contribution between two intentional tortfeasors, the court denied the right to contribution on the grounds that there can be no such right where the primary liability stems from an intentional wrongdoing.

²²⁶ The early American cases were consistent in allowing contribution between negligent wrongdoers but not between intentional ones. An easy and unfortunately common misinterpretation of *Merryweather v. Nixan*, 101 Eng. Rep. 1337 (K.B. 1799), apparently supplied some of the precedent for the later American no-contribution doctrine. While *Merryweather* actually pronounced the exception, the opinion also included a statement that there is to be no contribution between "tortfeasors." However, in 1799, when the *Merryweather* opinion was handed down, a "tort" was willful or intentional wrongdoing, and a "tortfeasor" was a willful or intentional wrongdoer. *Knell v. Feltman*, 174 F.2d 662, 666 (D.C. Cir. 1949). Many American courts thus concluded that no contribution should be granted between tortfeasors of any kind. *E.g.*, *Union Stock Yards Co. v. Chicago, B. & Q.R.R.*, 196 U.S. 217 (1905); *Gomes v. Brodhurst*, 394 F.2d 465, 467 (3d Cir. 1967); see W. PROSSER, *LAW OF TORTS* 306 (4th ed. 1971).

intentional analysis as it existed earlier.²²⁷ The no-contribution rule was based on the belief that a person's knowledge that he is responsible for all the consequences of a wrong would induce him to exercise a greater degree of care than he would exercise if he knew that any liability from a joint endeavor could be shared. Rejection of the rule has been based on a lack of faith in this proposition.²²⁸

An application of the strict American no-contribution rule would result in the denial of contribution between all defendants in securities law cases. An application of the intentional, non-intentional distinction would change this result only in those cases where certain defendants were subject to liability for non-intentional conduct.

Those few courts that have dealt with securities law contribution problems have looked to the express provisions in the federal securities acts dealing with contribution. In section 11(f) of the 1933 Act,²²⁹ and in sections 9(e) and 18(b) of the 1934 Act,²³⁰ express provision is made for contribution. Section 9(e) of the 1934 Act provides:

Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.²³¹

Section 18(b) contains only a very minor variation. The language of the 1933 Act is somewhat different but of the same effect:

[E]very person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.²³²

²²⁷ *George's Radio, Inc. v. Capital Transit Co.*, 126 F.2d 219 (D.C. Cir. 1942); see *Knell v. Feltman*, 174 F.2d 662 (D.C. Cir. 1949).

²²⁸ See *George's Radio, Inc. v. Capital Transit Co.*, 126 F.2d at 220. Several state legislatures also attacked the American no-contribution rule by enacting statutes that allow contribution among joint tortfeasors in certain circumstances, but these statutes are not uniform and provide little assistance. There has also been some activity in the field of adopting a Uniform Contribution Among Tortfeasors Act, but it has met with practically no success. See Note, *Aspects of the Right of Contribution Among Tortfeasors*, 33 TEMP. L.Q. 432 (1960).

²²⁹ 1933 Act § 11(f), 15 U.S.C. § 77k(f) (1970).

²³⁰ 1934 Act §§ 9(e), 18(b), 15 U.S.C. §§ 78i(e), 78r(b) (1970).

²³¹ *Id.* § 78i(e).

²³² 1933 Act § 11(f), 15 U.S.C. § 77k(f) (1970). As to the effect of the last clause ("unless . . .") which on its face seems redundant, the following explanation has been offered:

[I]t is probable, though not certain, that the parties liable on the registration statement may by contract allocate inter se their liability. There is no doubt but that such contracts were enforceable at common law. One exception to this under the Act is the case where the party suing was guilty of fraudulent misrepresentations while the party sued was not.

Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 178-79 (1933) (footnote omitted).

While no express provision for contribution was included in section 10(b) of the 1934 Act,²³³ the court in *deHaas v. Empire Petroleum Co.*²³⁴ utilized the above express statutory sections as a basis for implying such a right in a rule 10b-5 case. It reasoned very simply that the same reasons for allowing contribution under the express provisions for liability would apply under section 10(b) implied liability.²³⁵

The statutory language that expressly provides for contribution in both the 1933 and 1934 Acts includes, in each instance, the key phrase that the contribution is to be allowed "as in cases of contract."²³⁶ This provision in the 1933 Act was taken almost bodily from the British Companies Act, and probably reflects attempts to eliminate undesirable features present in the British common law as it existed in 1933.²³⁷ It was probably intended also to eliminate the policy denying contribution between intentional tortfeasors, as well as the American-invented no-contribution rule.²³⁸

The phrase "as in cases of contract" also aids in answering the question: "According to what method is the contribution to be allowed?" Theoretically contribution could be required either on a pro-rata basis or on some basis involving a degree of fault analysis. Since the Securities Acts incorporate the contract standard for contribution between tortfeasors, the pro-rata method used in common law contract cases should apply.²³⁹

The significance of allowing pro-rata contribution without regard to degree of fault is important to defendants. To the extent that contribution is permitted without regard to fault, the manner of defense,

²³³ 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1970).

²³⁴ 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part & vacated in part*, 435 F.2d 1223 (10th Cir. 1970).

²³⁵ *Id.* at 815-16 (citing 3 L. Loss, SECURITIES REGULATION 1739-40 n.178 (2d ed. 1961)).

²³⁶ None of the congressional committee reports on either act reveals a legislative interpretation of this phrase. 1933 Act: *See* S. REP. No. 47, 73d Cong., 1st Sess. (1933); H.R. REP. No. 85, 73d Cong., 1st Sess. (1933); H.R. REP. No. 152, 73d Cong., 1st Sess. (1933). 1934 Act: *See* S. REP. No. 792, 73d Cong., 2d Sess. (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. (1934); S. Doc. No. 185, 73d Cong., 2d Sess. (1934); H.R. REP. No. 1838, 73d Cong., 2d Sess. (1934).

²³⁷ Douglas & Bates, *supra* note 232, at 178 & n.30. The phrase eliminates the problem created by the death of one tortfeasor before judgment, and permits contribution from the executor of his estate. The doctrine that is avoided is "*actio personalis moritur cum persona*," literally, "a personal right of action dies with the person." *Batard v. Hawes*, 118 Eng. Rep. 775 (Q.B. 1853), indicates that in cases of a contract for contribution where one co-contractor dies before the action is brought, the executor of the deceased's estate is liable for his aliquot share.

²³⁸ *See* Douglas & Bates, *supra* note 232, at 178 n.30.

²³⁹ Where there are several defendants held liable, common law cases direct the payment of an equal share by each. *See, e.g.,* *Early Settlers Ins. Co. v. Schweid*, 221 A.2d 920, 923 (D.C. Ct. App. 1966). The pro-rata method is also easier to administer, and has been directed by the court in a securities case, *Globus, Inc. v. Law Research Serv., Inc.*, 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd in part & rev'd in part per curiam*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971).

decisions to implead other defendants, and considerations regarding settlement will be affected by the doctrine. If the damages will be large, defendants may wish to add as many other defendants as possible in order to spread the cost of ultimate liability.²⁴⁰

C. Indemnification

A determination that recovery by the plaintiff will be divided pro-rata between the defendants through the application of contribution principles does not eliminate the possibility that one wrongdoer may sue another wrongdoer seeking indemnity for his losses.²⁴¹ In contrast to contribution doctrine, the Securities Acts contain no specific provisions relating to indemnification. Although one court, the Fifth Circuit, has stated in dictum that indemnification between joint tortfeasors will not be allowed in a securities law case,²⁴² another court, the Second Circuit,²⁴³ has indicated that it would make indemnification available under appropriate circumstances.

In the absence of settled doctrine, common law principles of indemnity may be useful in providing background for deciding the proper approach in securities law cases. The most obvious common law illustrations involve situations in which the indemnified party is not at fault. For instance, many decisions in the respondeat superior field hold that the innocent master can obtain indemnity from his servant.²⁴⁴ Similarly, in non-delegable duty cases the person owing the

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²⁴⁰ Of course, the result may be different where the damages are assessed upon individual defendants under a theory calling for disgorgement of profits. *E.g.*, *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

²⁴¹ For a good review of the field, see Davis, *Indemnity Between Negligent Tortfeasors: A Proposed Rationale*, 37 *IOWA L. REV.* 517 (1952); Meriam & Thornton, *Indemnity Between Tort-Feasors: An Evolving Doctrine in the New York Court of Appeals*, 25 *N.Y.U.L. REV.* 845 (1950); W. PROSSER, *LAW OF TORTS* § 51 (4th ed. 1971); sources cited note 224 *supra*.

²⁴² *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 705 n.7 (5th Cir. 1969), *aff'g* 286 F. Supp. 340 (S.D. Tex. 1968).

²⁴³ See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1287-89 (2d Cir. 1969), *aff'g* 287 F. Supp. 188 (S.D.N.Y. 1968), *cert. denied*, 397 U.S. 913 (1970).

²⁴⁴ A typical example, and often cited case, is *Smith v. Foran*, 43 Conn. 244 (1875); *accord*, *Fedden v. Brooklyn E. Dist. Terminal*, 204 App. Div. 741, 199 N.Y.S. 9 (1923). Plaintiff in *Smith v. Foran* was a common carrier whose defendant-servant negligently damaged a piano that plaintiff was transporting and that was in defendant's care. Plaintiff paid the piano owners in settlement for the damage, and its action for indemnity from defendant was sustained.

The respondeat superior situation has particular application to those securities law cases where a corporation has been held liable for the unlawful activity of its directors, officers, or other agents. The corporation's cause of action for indemnity was established in *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 816 (D. Colo. 1968).

non-delegable duty may recover from a third party who actually caused the injury.²⁴⁵

Where an agent voluntarily and innocently commits a tortious act at the direction of his principal, the principal will usually be ordered to indemnify his agent. *Gower v. Emery*²⁴⁶ involved an agent who innocently attached certain properties at the direction of his principal, and who later was held liable in damages for trespass. In granting indemnity to the agent the court noted that:

In such a case, a promise of indemnity is implied, upon the principles of natural justice. Had the order been to do a known wrong, no such promise would have been implied. . . .

[I]f an agent, by order of his principal, commits a trespass upon the property of another, acting *bona fide*, without any suspicion of wrong, he has a claim for reimbursement upon his principal, for all the damages he sustains thereby.²⁴⁷

The common denominator in these three situations is that indemnity flows from one whose degree of fault is greater to one whose degree of fault is lesser. These situations do not present the crucial analogy for securities law cases, however, because in all of the examples the party seeking indemnification is innocent. In contrast, where concurrent wrongdoers are involved, the degree of fault question is the heart of the inquiry.

Various state jurisdictions have attempted to establish guidelines in cases involving concurrent wrongdoers, with little success in identifying helpful policy. One rationale is the "primary-secondary" test, under which the "primary" wrongdoer will indemnify the person whose activity was only "secondary."²⁴⁸ This primary-secondary test seems

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²⁴⁵ The most common example is the municipal corporation, which is held liable for injuries sustained by a person on its streets and sidewalks on the theory that it has a non-delegable duty to maintain its streets and sidewalks in a safe condition. When the hazard which causes the injury is created by a third party the municipal corporation is allowed indemnity. Typical of this group and often cited is *Washington Gas Light Co. v. District of Columbia*, 161 U.S. 316 (1896). There, damages had been recovered by an injured party from the District of Columbia for injuries sustained from a gas fixture protruding above the level of the sidewalk. The gas company had a duty to maintain and repair the gas fixture. The Court held that the District of Columbia had a cause of action against the gas company for indemnity. *Id.* at 327-28.

²⁴⁶ 18 Me. 79 (1841).

²⁴⁷ *Id.* at 83; *accord*, *Adamson v. Jarvis*, 130 Eng. Rep. 693 (1827); *Betts v. Gibbins*, 111 Eng. Rep. 22 (1834); *Moore v. Appleton*, 26 Ala. 633 (1855).

²⁴⁸ An Illinois appellate court has stated the test as follows:

The law of this State recognizes that a party who is only secondarily responsible for the plaintiff's injuries has a right to recover indemnity over against the person primarily responsible.

Reynolds v. Illinois Bell Tel. Co., 51 Ill. App. 2d 334, 336-37, 201 N.E.2d 322, 323 (1964).

For a classic case showing the difficulty of applying this test, see *American Dist. Tel. Co. v. Kittleston*, 179 F.2d 946, 951-52 (8th Cir. 1950).

only to be a restatement of the common denominator of the three earlier examples. It provides little help in measuring the degree of fault.

Some common law courts have approached the indemnification problem in a different manner, by establishing an "active-passive" dichotomy, under which indemnity will be allowed to one whose negligence is "passive," from one whose negligence is "active."²⁴⁹ Under this test, "active" negligence is defined as affirmative or positive activity, while "passive" negligence is the failure to do something that should have been done.²⁵⁰

Despite early approval of the active-passive test, state courts have found the test difficult to apply in a manner that assists in predicting outcome. The problem with the test is that the labels "active" and "passive" may merely be descriptive of the result which is desired. For instance, in *City of Weatherford Water, Light & Ice Co. v. Veit*,²⁵¹ a Texas case, a telephone company employee was injured by an electrical shock from an electric company's wires which ran parallel to, but below the telephone wires he was sent to repair. After paying damages to the employee, the electric company sought indemnification from the telephone company.²⁵² Indemnification was awarded on the theory that the electric company had been "passive" and the telephone company "active" in its negligence.²⁵³ In order to reach an opposite result in that case it would only have been necessary to reverse the descriptive terms, calling the telephone company "passive" and the electric company "active."

Dissatisfaction with the active-passive test has caused the Texas courts to drop that test in favor of one that analyzes the duties each tortfeasor owes to his co-tortfeasor. Under this theory, indemnity flows from the tortfeasor who has breached such a duty to one who has not.²⁵⁴ This theory, too, has failed to produce any certainty in the

²⁴⁹ Courts also express the dichotomy between the wrongs of the tortfeasors by a "commission-omission" test, which is but another formulation of the "active-passive" test. See, e.g., *City of Antonio v. Smith*, 94 Tex. 266, 271-72, 57 S.W. 1107, 1111 (1900); note 253 *infra*.

²⁵⁰ *English v. Miller*, 33 S.W.2d 477, 478 (Tex. Civ. App. 1930).

²⁵¹ 196 S.W. 986 (Tex. Civ. App. 1917).

²⁵² *Id.* at 989.

²⁵³ The court stated that maintaining the uninsulated high voltage wire on the telephone pole merely created a dangerous condition. This conclusion, however, is in contradiction to the general rule that the tortfeasor who has created the danger will be deemed "active." See, e.g., W. PROSSER, LAW OF TORTS § 52, at 312 (4th ed. 1971).

²⁵⁴ One district court made this summary of the change:

The right of indemnity has long been recognized to exist between joint tort-feasors where the negligence of the two was of a different degree of culpability. Many of the older cases have permitted indemnity in favor of one whose negligence was "passive" against the other whose negligence was "active", or in favor of one whose wrong was one of "omission" against the other whose wrong was one of "commission". . . . But this is a most

Texas law. In one Texas case the analysis produced three different results in three successive levels of litigation.²⁵⁵ Furthermore, the test seems no more than a statement that indemnity will be allowed from one concurrent tortfeasor to another if a different degree of fault can be shown.

None of the foregoing rationales seem to solve the indemnity dilemma when concurrent tortfeasors are involved. There is, however, a common thread based upon degree of fault, which may lead to sound doctrine where concurrent wrongdoers have breached securities laws. The court in *United States v. Savage Truck Lines, Inc.*²⁵⁶ used the degree of fault approach, stating:

In the infinite variety of circumstances where indemnity has been sought the courts have used various terms to distinguish between the *grade of fault* attributable to the participating wrongdoers so as to justify the imposition of the entire loss on the one who is regarded as the principal offender. The acts of the parties are variously contrasted as positive or negative . . . and as active and passive. . . .

. . . .

Whatever the terminology, the inquiry is always *whether the difference in the gravity of the faults of the participants is so great as to throw the whole loss upon one*. In such event there is contribution in the extreme form of indemnity.²⁵⁷

In seeking common law analogies for construction of proper contribution and indemnification doctrine under the securities laws, the *Restatement of Restitution* may provide a point of reference. Section 88 takes the position that "A person who has discharged a tort claim to which he and another were subject . . . is barred from restitution

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uncertain and unsatisfactory test, made to depend upon the manner of expression rather than the quality of the wrong.

In three recent cases . . . the Supreme Court of Texas seems to have laid aside the "passive" versus "active" negligence test and announced the rule that indemnity between tort-feasors lies only *where one tort-feasor breaches a duty which he owes to the other* (as distinguished from the breach of duty which each has committed as to the plaintiff).

Brown & Root, Inc. v. United States, 92 F. Supp. 257, 262-63 (S.D. Tex. 1950) (footnotes omitted). See generally Hodges, *Contribution and Indemnity Among Tortfeasors*, 26 TEXAS L. REV. 150 (1947).

²⁵⁵ *Humble Oil & Ref. Co. v. Martin*, 148 Tex. 175, 222 S.W.2d 995 (1949).

Still another proposed rationale for determining when to award indemnity from one concurrent tortfeasor to another suggests that the nature of the duties that each tortfeasor owes to the injured person should determine the result. Under this theory, indemnity should flow from the one who breached the less stringent duty to the one who breached the more stringent duty. Davis, *Indemnity Between Negligent Tortfeasors: A Proposed Rationale*, 37 IOWA L. REV. 517 (1952).

²⁵⁶ 209 F.2d 442 (4th Cir. 1953).

²⁵⁷ *Id.* at 446-47 (emphasis added).

if his tort involved seriously wrongful conduct.”²⁵⁸ The *Restatement* comment is the following:

c. Public policy prevents restitution in favor of a person who, whether or not by agreement with or at the request of another, has committed a seriously wrongful act. It is a matter for judicial discretion to determine whether an act is so seriously wrongful as to bar restitution under the particular circumstances. Normally consciously criminal conduct including dishonest conduct involving theft, embezzlement or fraud would be considered to be seriously wrongful. Likewise, a person is guilty of seriously wrongful conduct if he acts in reckless disregard of the interests of others; he is reckless if he acts knowing or having reason to know facts from which a reasonable man would realize that such conduct involves a high degree of probability of substantial harm to another.²⁵⁹

This *Restatement* position that serious misconduct will bar a claim for indemnification presents a reasonable rationale for securities law purposes. The *Restatement* position could be interpreted as saying that indemnification should be denied between parties who are equally culpable: a rule that one who has been seriously criminal, dishonest, or reckless in his conduct may not be indemnified by another says essentially that the culpability of a person seeking indemnification must be significantly different from that of the person from whom he hopes to receive such indemnification. Indemnification results under these theories would be consistent with a degree of fault analysis.

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²⁵⁸ RESTATEMENT OF RESTITUTION § 88(b) (1937).

²⁵⁹ *Id.*, comment on clause (b) at 395; See RESTATEMENT OF TORTS § 500 (1934).

The *Restatement's* position that a concurrent tortfeasor cannot claim restitution from another if his conduct is seriously wrong is repeated in § 89 of the *Restatement of Restitution* as follows:

§ 89. TORT INDUCED BY FRAUD.

A person who is induced by the fraud of another to believe that his conduct is lawful and in reliance upon that belief does an act because of which both are liable in tort, is entitled to indemnity from the other for expenditures properly made in the discharge of such liability if, as between the two, his reliance was justifiable.

Comment:

a. A person who, with reason to know of the consequences, knowingly makes a misrepresentation to another which induces the other to commit a tortious act is ordinarily himself liable for such tort. The same liability attaches where the tort is induced by the intentional failure to disclose facts by one having a duty to disclose them. Reliance upon the fraudulent misrepresentation and belief in its truth by the payor are essential to restitution, but it is not a bar to restitution that he was careless in so relying or believing. In accordance with the rule stated in § 88(b), however, the payor would be barred if his conduct was seriously criminal, dishonest or reckless.

Two cases, *deHaas v. Empire Petroleum Co.*²⁶⁰ and *Globus v. Law Research Service, Inc.*²⁶¹ have applied comparative fault concepts, illustrating approaches federal courts can be expected to take when dealing with indemnification in the securities law context.²⁶²

The *deHaas* case was a shareholders derivative action under rule 10b-5 against Empire Petroleum Company, American Industries, Inc., and Stone, who was the chief executive officer of both corporations. The complaint alleged that proxy materials used in connection with a merger were misleading and therefore violated rule 10b-5. Both Stone and Empire filed third-party complaints seeking indemnification and contribution from Loeffler, who had served as legal counsel for the corporations, alleging that Loeffler had prepared the misleading proxies.²⁶³ In response to a motion seeking to dismiss the third-party complaints, the court distinguished between the defendant Stone and the defendant Empire. With regard to Stone, the court stated that the plaintiffs could not succeed on the original complaint unless they could prove "that he knowingly participated in the allegedly fraudulent scheme."²⁶⁴ It then stated, "If Stone is found guilty of fraud on the main complaint, he would be *in pari delicto* with Loeffler, and would not be entitled to indemnification from him . . . ." ²⁶⁵ The court apparently acted on the theory that a defendant cannot obtain indemnification from another wrongdoer if the defendant is equally culpable.²⁶⁶

The court treated Empire's indemnification complaint differently, stating that since Empire's liability would attach only because of the fraudulent conduct of its agent, it would not be barred from seeking indemnification from those agents (officers and directors) "who directly

²⁶⁰ 286 F. Supp. 809 (D. Colo. 1968), 300 F. Supp. 834 (D. Colo. 1969), 302 F. Supp. 647 (D. Colo. 1969), *aff'd in part & rev'd in part*, 435 F.2d 1223 (10th Cir. 1970).

²⁶¹ 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part & rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

²⁶² The *Globus* case deals also with problems of contribution. One of the lower court opinions in that case expressed the proposition that both contribution and indemnity will be governed "by federal law." *Globus, Inc. v. Law Research Serv., Inc.*, 318 F. Supp. 955, 957-58 (S.D.N.Y. 1970), *aff'd in part & rev'd in part per curiam*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971). The court of appeals opinion expressly accepted the opinion of Judge Frankel reaching the latter conclusion. See also *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 705 n.7 (5th Cir. 1969) (dictum).

²⁶³ 286 F. Supp. at 815. The third-party complaint was filed under Fed. R. Civ. P. 14.

²⁶⁴ 286 F. Supp. at 815.

²⁶⁵ *Id.*

²⁶⁶ The result is also consistent with the *Restatement of Restitution* position that serious wrongdoing will bar indemnification. Note that despite the no-indemnification result, the court did not dismiss Stone's third-party complaint demanding contribution, ruling that contribution among intentional wrongdoers would be permitted under the Securities Acts. 286 F. Supp. at 815. See text accompanying notes 223-40 *supra*.

participate in the fraud.”²⁶⁷ In reaching this decision the court apparently adopted the degree of fault rationale permitting a principal to assert a claim of indemnification against his agent.²⁶⁸

The *Globus* case also involved a claim for indemnification in a securities law context. In that case, Law Research Service, Inc., sold stock to the public under regulation A pursuant to an offering circular held to be misleading. Both the company and the underwriter were found to be liable under the Securities Acts,²⁶⁹ but the underwriter, Blair & Co., asserted a claim for indemnification against Law Research Service, Inc., resting upon an indemnity clause in the underwriting agreement. Although Blair asserted that it was merely a passive joint tortfeasor, the Second Circuit noted that the jury had necessarily found “that Blair had actual knowledge of the material misstatements”²⁷⁰ and stated that “[i]t is well established that one cannot insure himself against his own reckless, willful or criminal misconduct.”²⁷¹ It advanced the rationale that to tolerate indemnity under such circumstances “would encourage flouting the policy of the common law and the Securities Act.”²⁷²

It is not clear whether the court was adopting a theory that intentional or reckless tortfeasors would be barred from seeking indemnification or whether it was engaged in a degree of fault analysis. An apparent willingness to rely on a degree of fault theory and perhaps to award indemnification may be found, however, in the court’s statement that it was considering “only the case where the underwriter has committed a sin graver than ordinary negligence.”²⁷³

The complementary relationship between indemnity principles and contribution principles was indicated when Blair later sought to obtain

²⁶⁷ *Id.* at 816 (citing *Handel-Maatschappi H. Albert De Bary & Co., N.V. v. Faradyne Electronics Corp.*, 37 F.R.D. 357 (S.D.N.Y. 1964)).

²⁶⁸ Later appeals in the *deHaas* case did not involve the contribution or indemnification points.

²⁶⁹ 1933 Act § 17(a), 15 U.S.C. § 77q(a) (1970); 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1970); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1971).

²⁷⁰ 418 F.2d at 1288.

²⁷¹ *Id.*

²⁷² *Id.* The denial of indemnity was also partially based on the views that such indemnity is contrary to public policy and that underwriters should be denied indemnity along with other controlling persons. This problem is beyond the bounds of this discussion, but has been extensively dealt with elsewhere. See Note, *Indemnification of the Corporate Insider: Directors' and Officers' Liability Insurance*, 54 MINN. L. REV. 667 (1970); Comment, *Insider Indemnification and the Supremacy Clause: The Three Faces of Fraud*, 63 NW. U.L. REV. 523 (1968); Comment, *Indemnification of Directors for Section 11 Liability*, 48 TEXAS L. REV. 661 (1970); Note, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933*, 72 YALE L.J. 406 (1962).

²⁷³ 418 F.2d at 1288. The court seemed to ignore this rationale, however, when it discussed the problems that would exist under § 11 of the 1933 Act if underwriters who might be subject to liability for negligence could pass their liability onto the issuer through indemnity agreements. The latter discussion might, however, be limited to § 11, which expressly provides for liability based upon negligence.

contribution from Law Research Services, Inc., and its president. The Second Circuit had earlier denied indemnification on the theory that such denial would "encourage diligence, investigation and compliance with the requirements of the statute by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages."²⁷⁴ In a later proceeding it agreed that contribution could be granted even though the two parties were equally culpable.²⁷⁵ It cited with approval a district court opinion stating that even though the two parties "stood equally culpable and equally responsible"²⁷⁶ contribution would be permitted. The lower court treated an attempt to escape contribution as equal to an attempt to gain indemnification. Either effort was viewed as an opportunity to nullify securities law liability "by leaving the whole of the burden" to the other concurrent tortfeasor.²⁷⁷

Although the *Globus* and *deHaas* decisions together stand for the proposition that equally culpable defendants will be able to obtain contribution, but will not be able to assert rights of indemnification,²⁷⁸ neither decision answers the basic question whether securities law defendants may assert rights of indemnification when the degrees of fault are substantially different. The question may be posed in another way as well: Will contribution be denied when the party seeking contribution is clearly more culpable than the party from whom he seeks contribution? A consistent answer to both of these questions based upon degree of fault analysis should result when one of two tortfeasors is substantially more culpable than the other. In that situation contribution would be denied to the more culpable party and indemnification would be awarded to the less culpable party. This result would be consistent with securities law policy by strengthening deterrence against more grievous wrongs while minimizing the effect of extending securities law liability.

Application of this result to parties liable under aiding and abetting or conspiracy theory would usually result in indemnification being denied and contribution being awarded. If earlier analysis in this Article regarding secondary defendants is correct, true secondary liability will attach only in those cases in which the defendant knew that the primary participant was engaged in an activity in violation of the securities laws and either rendered active assistance to him or affirmatively indicated his agreement to join the unlawful conduct.²⁷⁹ Under such

²⁷⁴ 418 F.2d at 1289.

²⁷⁵ *Globus, Inc. v. Law Research Serv., Inc.*, 442 F.2d 1346 (2d Cir. 1971), *aff'd in part* 318 F. Supp. 955 (S.D.N.Y. 1970).

²⁷⁶ 318 F. Supp. at 957.

²⁷⁷ *Id.* at 958.

²⁷⁸ Either by contract or by implication.

²⁷⁹ Text accompanying notes 146-211 *supra*.

circumstances it would seem difficult for a so-called secondary defendant to assert that his degree of fault was so significantly different from that of the primary defendant that indemnification should be allowed. On the other hand, if the earlier analysis is incorrect and liability can be imposed upon a secondary defendant for negligent conduct or for knowing failure to take action under circumstances in which no independent duty to take action exists,²⁸⁰ the differences in conduct might be sufficient to justify granting an implied right of indemnification.

D. In Pari Delicto

Although problems of contribution and indemnification have not received extensive analysis under the securities laws, the concept of degree of fault has been advanced in securities law cases and other cases as a means of deciding whether to accept a defense of unclean hands or *in pari delicto*.²⁸¹ One application of the *in pari delicto* defense is that a plaintiff who has participated in a wrong may not recover for his injuries.²⁸² The *in pari delicto* cases can help in identifying the degrees of fault that must exist in order to warrant indemnity.²⁸³ Although precise differentials cannot be identified, policies articulated in

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²⁸⁰ Text accompanying notes 146-211 *supra*.

²⁸¹ Literally "in equal fault," the phrase is sometimes used to deny indemnity. A basic statement of the *in pari delicto* rationale for denying indemnity is found in *Gray v. Boston Gas Light Co.*, 114 Mass. 149, 154 (1873):

When two parties, acting together, commit an illegal or wrongful act, the party who is held responsible in damages for the act cannot have indemnity or contribution from the other, because both are equally culpable, or *participes criminis*, and the damage results from their joint offence. This rule does not apply when one does the act or creates the nuisance, and the other does not join therein, but is thereby exposed to liability and suffers damage. He may recover from the party whose wrongful act has thus exposed him. In such cases the parties are not *in pari delicto* as to each other, though as to third persons either may be held liable.

The court's use of the word "contribution" is not proper, but such misuse is not uncommon. See *Middlesboro Home Tel. Co. v. Louisville & N.R.R.*, 214 Ky. 822, 284 S.W. 104 (1926); *Cincinnati & C.R.R. v. Louisville & N.R.R.*, 97 Ky. 128, 30 S.W. 408 (1895); *Churchill v. Holt*, 127 Mass. 165 (1879), 131 Mass. 67 (1881). This *in pari delicto* rationale for determining an award of indemnity has been subject to attack. It may be contended that a statement to the effect that the parties are *in pari delicto*, and, therefore, are to be denied indemnity, is no more than symptomatic of a conclusion already reached. The analysis which follows is intended, in part, to dampen this criticism as regards indemnity in securities lawsuits.

²⁸² The typical pleading situation that gives rise to these cases involves receipt of a complaint demanding damages followed by defendant's motion to dismiss on the ground that plaintiff's own conduct bars his recovery. Sometimes the defendant asserts an *in pari delicto* defense, sometimes he claims that the plaintiff has unclean hands, and sometimes he maintains that the plaintiff is contributorily negligent. Regardless of the defendant's description, defendant is claiming that the law will not allow the pot to call the kettle black.

²⁸³ An analysis of the *in pari delicto* defense has been made, and in greater detail than it will be made here, in Bell, *How to Bar an Unimposed Investor—The Validity of Common Law Defenses to Private Actions Under the Securities Exchange Act of 1934*, 23 U. FLA. L. REV. 1 (1970). See also Comment, *Plaintiff's Conduct as a Bar to Recovery Under the Securities Acts: In Pari Delicto*, 48 TEXAS L. REV. 181 (1969).

cases dealing with the *in pari delicto* defense will be useful in considering the indemnification-contribution degree of fault doctrines.

The securities law cases dealing with the *in pari delicto* defense seem to rest on either of two familiar securities law policies. One is that deceptive and manipulative practices should be deterred. The other is that members of the investing public should be able to recover when wronged. These two objectives, deterrence and compensation, do not necessarily result in consistent application of the *in pari delicto* doctrine.

The deterrence policy sometimes supports the *in pari delicto* defense on the theory that to allow the plaintiff to recover where he participated in the wrong would be to encourage fraudulent practices. Cases following this approach usually hold that the plaintiff is *in pari delicto* and grant the motion to dismiss. For instance, in *Kuehnert v. Texstar Corp.*²⁸⁴ plaintiff bought Texstar stock on the basis of a false tip. In granting defendant's motion to dismiss on the ground that plaintiff was *in pari delicto* the district court stated that "the tippee . . . must be painted with the same brush and the same color as the insider from whom the tippee receives his information."²⁸⁵

The *in pari delicto* defense has been used to bar plaintiffs' suits based on alleged violations of regulations T²⁸⁶ and U.²⁸⁷ In *Serzysko*

²⁸⁴ 286 F. Supp. 340 (S.D. Tex. 1968), *aff'd*, 412 F.2d 700 (5th Cir. 1969).

²⁸⁵ *Id.* at 345. The court of appeals elaborated on the policy aspects as follows: It is true that if a tippee has no remedy against an insider's private falsehoods, little deterrent against such conduct will exist; the insider may have free rein. But, as against this, there is another danger. If a tippee can sue he has, in effect, an enforceable warranty that secret information is true. It is then he that will have free rein. . . .

. . . [I]n view of the substantial deterrent pressures already felt by the corporate insider, SEC v. Texas Gulf Sulphur Co. [401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)] we think it important that tippees, who present the same threat to the investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls.

412 F.2d at 705. Relying on the *Kuehnert* reasoning, the court in *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970), also granted a motion to strike defenses based upon the *in pari delicto* doctrine. In *Wohl*, plaintiffs sued a broker, claiming they had made stock purchases based upon false tips supplied by him. Plaintiffs attempted to distinguish *Kuehnert* on the basis that where inside information is received through a broker, application of the *in pari delicto* defense would encourage brokers to defraud. The court rejected the plaintiffs' argument, emphasizing that the anti-inside information policy of the securities laws precludes their recovery. The defense has, however, been rejected in a similar case, *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

²⁸⁶ While the issue of plaintiffs' actual participation in the alleged violations of regulation T, 12 C.F.R. §§ 220.1-8 (1971), was deemed to be a triable issue which could not be determined by a summary judgment, the court in *Moscarelli v. Stamm*, 288 F. Supp. 453, 459-60 (E.D.N.Y. 1968) stated:

It is fairly obvious that Congress did not intend to protect investors at all times and under all circumstances regardless of their conduct.

It follows that the [defendant] broker's implied civil liability is not absolute but is subject to the traditional tort concepts of causation and contributory negligence or analogous conduct.

²⁸⁷ 12 C.F.R. §§ 221.1-4 (1971).

*v. Chase Manhattan Bank*²⁸⁸ plaintiff sued for damages caused by loans allegedly made to him in violation of regulation U. The court noted that the plaintiff had induced the wrong and denied relief:

It is the view of the Court that to allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act.²⁸⁹

The compensation perspective usually has resulted in the denial of the *in pari delicto* defense. This approach includes as those deserving protection even persons who have been involved in the schemes. The Supreme Court noted the overriding effect of legislative policy by denying the unclean hands defense in *A. C. Frost & Co. v. Coeur d'Alene Mines Corp.*,²⁹⁰ a case involving unregistered securities. Application of the compensation theory in credit regulation cases usually has caused the *in pari delicto* defense to be denied. For instance, in *Remar v. Clayton Securities Corp.*,²⁹¹ the defendant broker-dealer had arranged for loans to be made to the plaintiff to finance stock purchases in violation of regulation U. In denying an *in pari delicto* defense, the court stated:

Broadly stated, the rule is that where defendant's violation of a prohibitory statute has caused injury to plaintiff, the latter

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²⁸⁸ 290 F. Supp. 74 (S.D.N.Y.), *aff'd per curiam*, 409 F.2d 1360 (2d Cir. 1968), *cert. denied*, 396 U.S. 904 (1969).

²⁸⁹ 290 F. Supp. at 89-90.

²⁹⁰ 312 U.S. 38 (1941). This case was concerned with a violation of the registration provisions of the 1933 Act. Plaintiff had attempted to enforce an option contract by which he was to be credited with the proceeds in excess of 10 cents per share from the sale of stock of Coeur d'Alene Mines Corporation being sold by that company. The company defended the suit on the grounds that the original contract called for sale in violation of the registration provisions of the 1933 Act and was therefore void and unenforceable. The Idaho Supreme Court agreed, but the Supreme Court of the United States reversed, primarily in reliance upon an SEC memorandum suggesting that if this contract was "void" no contract between an issuer and an underwriter could be enforced if the registration provisions were violated. The SEC had said:

It is obvious that the purposes of the Act would be defeated by any judicial doctrine which prevented the issuing corporation from recovering from the underwriter, and putting to the intended use in its business, the money invested by the public in the issuer. And it would be anomalous to rest such an injury to the investors upon the fact that the transaction in which the securities were distributed violated the Act, which was designed to protect those investors. . . .

It appears to us to be entirely immaterial whether in such a case, the agreement is labelled "void" or the parties are held to be "in pari delicto." There, labels, as often is the case, merely state the conclusion reached, but do not aid in solution of the problem. *The ultimate issue is whether the result in the particular case would effectuate or frustrate the purposes of the Act.*

Id. at 43-44 n.2 (emphasis added).

²⁹¹ 81 F. Supp. 1014 (D. Mass. 1949).

has a right of action if one of the purposes of the enactment was to protect individual interests like the plaintiff's.²⁹²

Although it can be expected that courts will continue to use the deterrence and compensation policies to justify application or non-application of the doctrine of *in pari delicto* in securities law cases, the conflicting nature of these two objectives yields little promise for predictability. If the degree of fault analysis is added to the *in pari delicto* cases, however, the policy of protecting the general investing public by providing compensation will be favored. Under this approach, unless the degrees of fault are truly indistinguishable or the fault of the plaintiff is clearly greater, the defense of *in pari delicto* should not be allowed and the plaintiff should be compensated.²⁹³

A degree of fault analysis was employed by the court in *Can-Am Petroleum Co. v. Beck*.²⁹⁴ There, the plaintiff sued to recoup money she had paid to defendant for an undivided interest in certain oil and gas leases, on the ground that the securities were not registered in accordance with the 1933 Act. Plaintiff also had encouraged other investors to purchase similar interests in return for a greater fractional share interest for herself. In rejecting defendant's *in pari delicto* defense, the Tenth Circuit stated:

One who sells securities in violation of the Act will find no comfort in his own incidental investment when he seeks recovery against his equally culpable associates. . . . But an investor does not waive or lose the shelter of the Act because he becomes to some extent involved in the illegality of the security sales. The reason for such a rule has been aptly stated: "In such event, since the policy of the law designed to discourage illegal agreements comes in conflict with that policy which demands the effective enforcement of the Corporate Securities Act, the law differentiates the guilt of the parties, because refusal of relief to the less culpable would involve harmful effects wholly out of proportion to the requirements of individual punishment or the discouragement of illegal contracts."²⁹⁵

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²⁹² *Id.* at 1017. Answering the question of whether the plaintiff's right of action was affected by his participation as borrower in the transaction in which the broker-dealer had violated the statute, the court stated that:

Since the statute was passed for the benefit of people like plaintiff, and since the Legislature regarded him as incapable of protecting himself, he is not disabled from suing for the injury he sustained.

Id.

²⁹³ Clearly the question whether the defense of *in pari delicto* will be permitted "rests in the sound discretion of the trial court." *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

²⁹⁴ 331 F.2d 371 (10th Cir. 1964).

²⁹⁵ *Id.* at 373, quoting *Miller v. California Roofing Co.*, 55 Cal. App. 2d 136, 143-144, 130 P.2d 740, 745 (1942); see Note, *Corporate Indemnification for 10b-5 Violations*, 70 COLUM. L. REV. 504 (1970).

Plaintiff was found to have "adulterated" her stance as a pure investor when she assisted in selling the securities to others, "but she at no time had the degree of culpability attributed to defendants and should not be considered as *in pari delicto*." ²⁹⁶

The most authoritative acceptance of a degree of fault analysis with regard to the *in pari delicto* defense appears in the United States Supreme Court decision in an antitrust case, *Perma Life Mufflers, Inc. v. International Parts Corp.*²⁹⁷ Plaintiffs in *Perma Life* sought to recover damages based upon illegal contracts to which they were a party. The several opinions in that case, which denied an *in pari delicto* defense, collectively point toward acceptance of a degree of fault theory. The majority opinion (written by Justice Black) seemed to acknowledge that a truly active plaintiff would be barred: "[w]e need not decide, however, whether such truly complete involvement and participation in a monopolistic scheme could ever be a basis, wholly apart from the idea of *in pari delicto*, for barring a plaintiff's cause of action, for in the present case the factual picture respondents attempt to paint is utterly refuted by the record." ²⁹⁸ The four additional opinions recognize the general principle that the doctrine of *in pari delicto* will be available when the parties are relatively equal in fault.²⁹⁹

²⁹⁶ 331 F.2d at 373-74. See also *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941). The equal fault prerequisite for sustaining an *in pari delicto* defense was stressed in *Carpenter v. Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970). There the court, finding that Westec was not in equal fault with defendants, dismissed an *in pari delicto* defense. *Id.* at 1106.

²⁹⁷ 392 U.S. 134 (1968). See generally Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241 (1965); Note, *Unclean Hands: The Effect of Plaintiff's Antitrust Violations in Antitrust Actions*, 113 U. PA. L. REV. 1071 (1965). Two cases that are important as background to the current law are *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*, 340 U.S. 211 (1951), and *Pennsylvania Water & Power Co. v. Consolidated Gas Elec. Light & Power Co.*, 209 F.2d 131 (4th Cir. 1953).

²⁹⁸ 392 U.S. at 140.

²⁹⁹ The relevant language is as follows:

Justice White (concurring):

Generally speaking, however, I would deny recovery where plaintiff and defendant bear substantially equal responsibility for injury resulting to one of them but permit recovery in favor of the one less responsible where one is more responsible than the other.

Id. at 146.

Justice Fortas (concurring in result):

If the fault of the parties is reasonably within the same scale—if the "*delictum*" is approximately "*par*"—then the doctrine should bar recovery.

. . . But equality of position of this general nature is necessary before *in pari delicto* may apply to bar an antitrust remedy.

Id. at 147.

Justice Marshall (concurring in result):

I would hold that where a defendant in a private antitrust suit can show that the plaintiff actively participated in the formation and implementation of an illegal scheme, and is substantially equally at fault, the plaintiff should be barred from imposing liability on the defendant.

Id. at 149.

Securities law cases treating the *in pari delicto* defense decided since the *Perma Life* case generally have accepted the degree of fault analysis. In *Pearlstein v. Scudder & German*,³⁰⁰ the court denied the defense of *in pari delicto* in a suit by a customer charging his broker with violation of regulation T. Nevertheless, the court distinguished two cases reaching an opposite result³⁰¹ on the grounds that in those cases the kind of fault attributed to the customer went "beyond knowledge of the margin requirements to concealment or misstatement of material facts."³⁰² In *Nathanson v. Weis, Voisin, Cannon, Inc.*,³⁰³ the court dealt with the contention that a tippee should not be able to assert liability against a tipper broker-dealer who gave a false tip. Relying on the *Perma Life* case, the court rejected the *in pari delicto* defense, noting that in the usual situation the positions of the tipper and tippee are "not necessarily equal."³⁰⁴ It added:

The true insider or the broker-dealer is at the fountainhead of the confidential information, whereas the tippee or the customer may be only one of many who innocently or otherwise receives a tip, and whose potential for harm is minimal as compared to that of the original source of the information.³⁰⁵

The court stated that the policy of discouraging the tipper from making the initial disclosure "can most readily be achieved by making unavailable to him the defense of *in pari delicto* when sued by his tippee upon charges based upon alleged misinformation."³⁰⁶

In a recent case also involving a claim by a customer against a broker-dealer, the District of Columbia District Court denied the defense of *in pari delicto* based upon mere knowledge of a regulation T violation.³⁰⁷ It concluded that "mere participation in or knowledge of a violation without fraud or deceit is not enough to deny the plaintiff recovery."³⁰⁸

Justice Harlan, joined by Justice Stewart (concurring in part and dissenting in part):

Plaintiffs who are truly *in pari delicto* are those who have themselves violated the law in cooperation with the defendant.

Id. at 153 (footnote omitted).

³⁰⁰ 429 F.2d 1136 (2d Cir. 1970).

³⁰¹ *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd per curiam*, 409 F.2d 1360 (2d Cir.), *cert. denied*, 396 U.S. 904 (1969); *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968).

³⁰² 429 F.2d at 1142 n.10.

³⁰³ 325 F. Supp. 50 (S.D.N.Y. 1971).

³⁰⁴ *Id.* at 57.

³⁰⁵ *Id.*

³⁰⁶ *Id.* at 57-58.

³⁰⁷ *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677, 680 (D.D.C. 1971) (citing *Perma Life Mufflers* and distinguishing *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968), and Judge Friendly's dissent in *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1147-48 (2d Cir. 1970)).

³⁰⁸ 328 F. Supp. at 680.

III. CONCLUSION

The policy judgment the courts have made by using degree of fault analysis in the *in pari delicto* cases is consistent with the suggestion in this Article that degree of fault analysis is also appropriate in cases involving contribution and indemnity. Both the deterrent and the compensation securities law policies will be advanced by permitting contribution in all cases except where there is a clear difference in fault, since the entire burden of loss will not be shifted from one guilty party to another merely through the accidents of jurisdiction or plaintiff's selection of defendants. In suits for indemnity both deterrence and fairness will be increased by granting indemnity only in those cases in which the difference of degree of fault is great.

The policies underlying application of contribution, indemnity, and *in pari delicto* doctrines become extremely important to those defendants whose liability is secondary. Defendants whose liability is primary because of their direct participation in the fraudulent activity or because they have violated an independent duty most likely will be judged to have a degree of fault high enough so that indemnity will not be awarded them and a defense of *in pari delicto* will not be available. Where the liability is based upon theories such as aiding and abetting or conspiracy, however, the culpability of the various defendants may be so different that both securities law objectives and fairness can be achieved by application of sound doctrines of degree of fault. Need for degree of fault analysis in deciding whether to allow the defense of *in pari delicto*, to impose indemnification, or to deny contribution would arise most clearly if secondary liability is imposed for inaction or for failure to make proper inquiry (a development which has been opposed in this Article). Although courts may shrink from the task of determining relative degrees of fault, evaluation of the relative culpability of the parties should lead to fair adjustment of the liabilities and rights of multiple defendants. Since recoveries based upon rule 10b-5 and other securities law sections and rules seem to stem in large part from common law tort and restitution doctrines, there seems every reason to temper securities law liability with considerations of fault and fairness.