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## I. Introduction

The rules for imputing the knowledge of an agent to a corporation are generally dictated by common law principles of agency. Courts have shown some reluctance, however, to impute the knowledge of a subordinate agent to the corporation in criminal and civil fraud actions requiring scienter. This reluctance has led courts to place inconsistent limits on the operation of agency principles in actions involving corporations. The Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[1] requiring a finding of scienter as a prerequisite to liability under Rule 10b-5, reinforces the need for uniform guidelines in determining when a corporation possesses the requisite "guilty mind" for liability. Due to the nature and purposes of the Securities Exchange Act of 1934, the courts should draw standards for imputing knowledge which will prevent corporations from avoiding liability by disclaiming the scienter of those performing functions which influence investors' decisions.

This paper first briefly discusses some general agency principles applicable to corporate knowledge and traces the historical development of corporate criminal liability. Discussed next are the limits courts have placed on imputing the knowledge of subordinate employees to corporations. The paper then examines the applicability of common law agency doctrines to the Securities Exchange Act of 1934 and concludes with suggestions for limits on the use of agency principles in the corporate setting.

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1. 425 U.S. 185 (1976).

## II. General Agency Principles

The Restatement (Second) of Agency section 272 states the general rule that the liability of a principal is affected by its agent's knowledge "whenever the knowledge is of importance in the act which the agent is authorized to perform."[2] This rule charges a corporation with constructive knowledge of all material facts actually or constructively known by its agent while acting within the scope of her authority.[3] Subject to certain exceptions, the law conclusively presumes that the agent has disclosed the information to the principal, even though the agent does not in fact communicate the knowledge.[4] The person through whom the knowledge is imputed must either be the agent of the corporation at the time of acquiring the knowledge, or must become an agent and have the knowledge in her mind at the time of the transaction to which notice is sought to be imputed.[5] The knowledge must be acquired within the scope of the agent's duties and must be material.[6]

The common law agency principles of corporate knowledge and respondeat superior, despite being used somewhat interchangeably by some courts, are based on different premises. The imputation of knowledge from agent to principal is based on an irrebuttable presumption that the agent will perform her duty to communicate knowledge received in the course of her agency to the principal. The doctrine does not operate to impute knowledge when the agent acts adversely to the principal. Respondeat superior is based on the premise that a principal who acts through its agents will be bound by acts of the agent within the agent's actual or apparent authority.

The two doctrines of corporate knowledge and respondeat superior differ in scope, with some overlap. Corporate knowledge

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2. Restatement (Second) of Agency § 272 (1958) states that the knowledge may be of importance when:

> 1. an agent makes a contract for the principal or acts in the execution of a contract;
> 2. the conduct of an agent or principal interferes with the protected interests of another and thereby may constitute a tort against such other;
> 3. an agent acquires property for the principal; or
> 4. an agent is employed by the principal to act in relation to a matter and to make reports concerning it to the principal or to other agents of the principal.

3. W. Fletcher, Cyclopedia of Corporations § 790 (rev. perm. ed. 1986).

4. *Id.*

5. *Id.*

6. *Id.*

deals with *knowledge obtained by an agent*, while respondeat superior deals with *acts performed by the agent*. Under the corporate knowledge doctrine, a principal is not held to possess the knowledge of an agent obtained while acting adversely to the principal. A principal may be held liable under respondeat superior for the acts and intent of an agent outside of her actual agency, even if acting adversely to the principal, when the principal cloaks the agent with ostensible authority.

## III. Criminal Corporate Liability

### A. *Background*

Prior to the advent of private corporations, the common law had established the notion that where there is no wilfulness, there is no guilt. This view is summarized in the opening statement of Hawkins' famous treatise, *Pleas of the Crown*: "The guilt of offending against any law whatsoever, necessarily supposing a wilful disobedience thereof, can never justly be imputed to those who are either incapable of understanding it, or of conforming themselves to it."[7]

Early American courts, adopting the common law view, initially held that a corporation could never be guilty of a crime as a fictional entity was incapable of possessing a culpable mental state.[8] The first cases holding corporations criminally liable involved mainly public welfare offenses, including nuisance situations and violations of regulatory statutes.[9] Liability was imposed in these cases without regard to mens rea, as the remedy sought was simply either to abate a nuisance or to protect public health or safety.[10] The earliest statutory provisions explicitly holding corporations criminally liable were those creating standards of care for corporations operating railroads.[11]

The first case relying on common law principles to impute intent to a corporation was *New York Central & Hudson River*

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7. 1 W. Hawkins, A Treatise of Pleas of the Crown 1 (1716).

8. Note, *Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority*, 35 Vand. L. Rev. 1383, 1413 (1982); *see, e.g.*, State v. Morris & Essex R.R., 23 N.J.L. 360, 370 (1858).

9. *See* Elkins, *Corporations and the Criminal Law: An Uneasy Alliance*, 65 Ky. L.J. 73, 98 (1976).

10. *Id.*

11. *Id.* at 98.

*Railroad v. United States.*[12] In *New York Central*, the Court considered the constitutionality of a statute which provided, in part, "the act, omission or failure of any officer, agent or other person acting for or employed by any common carrier, acting within the scope of his employment, shall in every case be also deemed to be the act, omission or failure of such carrier, as well as that person."[13]

The corporate petitioner, seeking to overturn its conviction, argued that holding a corporation liable for the acts of its servants was "to take the property of every stockholder," and was in effect "punishing the innocent for the guilty."[14] In upholding the validity of the statute, the Court began its analysis by noting that tort liability for corporations at that time had been already well established.[15] While acknowledging there were certain crimes a corporation could not commit, the court feared that if corporations were not charged with the knowledge and purposes of their agents, many offenses would go unpunished.[16] The Court failed to find any credible argument why corporations should not be held liable for certain types of offenses, namely those in which corporations were mentioned specifically or where liability attached without regard to mental state.[17]

While the early cases holding corporations criminally liable dealt with statutes which by their terms dictated the imputation of agents' acts and intentions, courts no longer feel bound to limit corporate liability to those situations. Statutes which are directed to "any person" or "whoever" are regularly construed by the courts as imposing criminal liability on corporations.[18]

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12. 212 U.S. 481 (1909).

13. *Id.* at 491-92.

14. *Id.* at 482.

15. *Id.* at 493 (citing Lake Shore & Michigan Southern R.R. v. Prentice, 147 U.S. 101, 109, 111 (1893)).

16. *Id.* at 494-95.

17. *Id.* at 494. The court cited as contemporary authority supporting their position, BISHOP'S NEW CRIMINAL LAW § 417, which states:

> Since a corporation acts by its officers and agents their purposes, motives and intent are just as much those of the corporation as are the things done. If, for example, the invisible, intangible essence of air, which we term a corporation, can level mountains, fill up valleys, lay down iron tracks, and run railroad cars on them, it can intend to do it, and can act therein as well viciously as virtuously.

*New York Central*, 212 U.S. at 492-93.

18. Elkins, *supra* note 9, at 99.

### B. *Extent To Which Knowledge Will Be Imputed*

Once courts surmounted the hurdle of imputing intent to corporations,[19] the next issue was how far up in a corporate hierarchy must an employee be for her intent to be imputed. Courts generally have had no difficulty imputing the intent of officers or directors for misdeeds committed in their official capacity.[20] Likewise, courts have not been reluctant to impute the intent of middle-level managers and supervisors.[21]

Courts have been willing to impute the intent of subordinate employees in certain circumstances.[22] For example,

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19. One of the first cases which resolved this issue was Telegram Newspaper Co. v. Commonwealth, 172 Mass. 294, 52 N.E. 445 (1899). In that case, the court used the doctrine of respondeat superior to uphold a corporation's criminal contempt conviction. The court found "no more difficulty in imputing to a corporation a specific intent in criminal proceedings than in civil." The court recognized that a corporation may be neither arrested nor imprisoned, but stated that "its property may be taken either as compensation in a private wrong or as punishment for a public wrong." *Id.* at 297, 52 N.E. at 446.

20. *See, e.g.*, Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

21. *See, e.g.*, United States v. Hayes Int'l Corp., 786 F.2d 1499 (11th Cir. 1986); United States v. Dye Constr. Co., 510 F.2d 78 (10th Cir. 1975); United States v. American Radiator & Standard Sanitary Corp., 433 F.2d 174, 204-05 (3d Cir. 1970), *cert. denied*, 401 U.S. 948 (1971); United States v. Milton Marks Corp., 240 F.2d 838, 839 (3d Cir. 1957); United States v. Steiner Plastics Mfg., 231 F.2d 149 (2d Cir. 1956).

For example, in Apex Oil Co. v. United States, 530 F.2d 1291 (8th Cir.), *cert. denied*, 429 U. S. 827 (1976), an employee of Apex Oil, in charge of an offloading operation at an Apex facility, witnessed a small oil spill which occurred during the operation. The employee failed to inform either the Coast Guard or the Environmental Protection Agency of the spill. No officer or director of Apex had any knowledge of the spill. The court of appeals upheld the conviction of Apex under the Water Pollution Control Act, section 311(b)(5), which requires that "any person in charge" having knowledge of an oil spill report such spill to an agency of the federal government. *Id.* at 1292 (citing 33 U.S.C. § 1321(b)(5) (1982)). Apex first argued that a corporation could not be a "person in charge" under the statute. The court found that the Act was designed to insure that as far as possible small spills will not go undetected. *Id.* at 1292-93. The court held that this purpose would be best served by holding the corporation responsible. Apex's second argument was that, even if the corporation was in charge, that it had no knowledge of the spill. The court responded that the knowledge of the supervisory employee was the knowledge of the corporation. *Id.* at 1295.

22. *See, e.g.*, St. Johnsbury Trucking Co. v. United States, 220 F.2d 393, 398 (1st Cir. 1955); United States v. George F. Fish, Inc., 154 F.2d 798, 801 (2d Cir.), *cert. denied*, 328 U.S. 869 (1946); Boise Dodge, Inc. v. United States, 406 F.2d 771 (9th Cir. 1969); Steere Tank Lines, Inc. v. United States, 330 F.2d 719 (5th Cir. 1963); Riss & Co. v. United States, 262 F.2d 245 (8th Cir. 1958); United States v. Armour & Co., 168 F.2d 342 (3d Cir. 1948); United States v. George F. Fish, Inc., 154 F.2d 798 (2d Cir.), *cert. denied*, 328 U.S. 869 (1946). *But see* United States v. Little Rock Sewer Committee, 460 F. Supp. 6, 9 (E.D. Ark. 1978) (although the issue was not before the court, the court "would have trouble with" the broad proposition that the knowledge of low echelon employees may be imputed).

in *United States v. George F. Fish, Inc.*,[23] a wholesale dealer in fruits and vegetables, along with its salesman, was convicted of "unlawfully, wilfully and knowingly" evading certain provisions of the Emergency Price Control Act of 1942.[24] The corporate defendant appealed its conviction, claiming that the guilt of its salesman could not be attributed to it.[25] In rejecting this contention, the court found the case for imputing the wilful violation of a subordinate strong, as the sales prohibited by the Act would almost invariably be performed by subordinate salesmen.[26] The court found that the purpose of the Act was to create a deterrent; to deny the possibility of corporate responsibility for the acts of subordinate employees would be to immunize the offender who really benefits from the wrongful act.[27]

Many courts, however, recognizing that corporate knowledge is a legal fiction, have sought to create limitations on imputing the knowledge and intent of subordinate employees, attempting to ensure fairness to both the plaintiff and the defendant corporation.

*1. Linkage requirement*

An early case limiting the imputation of a subordinate employee's intent was *People v. Canadian Fur Trappers Corp.*[28] In that case, the corporate defendant was charged with its salesman's larceny in connection with the sale of a fur coat. In reversing the conviction, the court held that the intent to steal must be the intent of the corporation and not merely of the intent of the low level agent.[29] The court limited criminal liability for crimes committed by employees which were either acquiesced in or authorized by corporate officers.

The view in *Canadian Fur Trappers*, while not widely accepted by the courts, found favor with Professor Mueller in his article, *Mens Rea and the Corporation*.[30] Professor Mueller espoused the view that since the shareholders are the ones who ultimately bear the burden of corporate liability, the only knowl-

23. 154 F.2d 798, 799 (2d Cir. 1946).
24. 50 U.S.C. §§ 904, 925(b) (1982).
25. 154 F.2d at 801.
26. *Id.*
27. *Id.*
28. 248 N.Y. 159, 161 N.E. 455 (1928).
29. *Id.* at 163, 161 N.E. at 456.
30. 19 U. PITT. L. REV. 21 (1957).

edge of a corporation consists of the knowledge of those in whom the shareholders have entrusted the direction and supervision of the corporation.[31] He refers to this group of officers, elected or appointed, who direct, supervise and manage the corporation as the "inner circle." His view is that it is proper to recognize only the direct acts and intents of the members of this group, along with the acts authorized, requested or commanded by these officers, as those of the corporation.[32]

This approach would not act as a limitation on vicarious liability where a "link" is established between the subordinate actor and the "inner circle."[33] Such a "link" would exist where it could be shown that those of the "inner circle" had actual or constructive knowledge of the acts of the subordinate employee.[34] Constructive knowledge may be imputed where the acts committed are an established practice or a course of business.[35] If the acts of the subordinate employees have been performed methodically or continuously over a period of time, a presumption may arise that the acts were either acquiesced in or sanctioned by the "inner circle." The burden would then be placed on the corporation to show the members of the "inner circle," and hence the corporation, had no knowledge of the wrongful acts.[36]

### 2. *Employee function test*

In *C.I.T. Corp. v. United States*,[37] a lender was charged with "knowingly" making false credit applications to the Federal Housing Administration. The defendant corporation argued that the area office manager was too low in the corporate hierarchy to bind the company and "had no corporate power to commit such acts of bad faith with a criminal intent imputable to the corporate entity."[38] Rejecting this contention, the court held that it is the function delegated to the agent that determines his power to engage the corporation in a criminal transaction.[39]

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31. *Id.* at 40-41.
32. *Id.* at 41.
33. Elkins, *supra* note 9, at 109; *see also* Note, *supra* note 8, at 1415.
34. Elkins, *supra* note 9, at 109.
35. *Id.*
36. *Id.*
37. 150 F.2d 85 (9th Cir. 1945).
38. *Id.* at 89.
39. Additionally, the court found it important that the manager acted on behalf of the corporation and not for his personal benefit. *Id.* at 89.

The "function" test may really be nothing more than a way of stating that an employee is acting within the scope of his authority. The analysis applied as a strict litmus test would, however, limit respondeat superior in those cases where an employee is acting outside her delegated authority, but within her ostensible authority.

### 3. *Beneficial purpose test*

A number of courts have found an employee's motivation important in determining whether to impute the wrongful intent of the employee to a corporation.[40] At least one court has found that a purpose to benefit the corporation is a prerequisite to imputing the intent of a subordinate employee. In *Standard Oil Co. of Texas v. United States*,[41] a pipeline corporation was convicted of "knowingly" violating the Connolly Hot Oil Act.[42]

The court noted first that "a corporation may be criminally bound by the acts of subordinate, even menial, employees."[43] The court, however, reversed the conviction, explicitly rejecting the "function" test applied by the district court.[44] The court found that the decisive issue in imputing the agent's actions and intent to the corporation was whether the employee acted for the purpose of benefiting his employer.[45] It was held unimportant whether any actual benefit had been received in fact—if done for the purpose of furthering the master's business, the "act is no less the principal's if . . . no benefit accrues, a benefit is undiscernible, or . . . the result turns out to be adverse."[46] The test applied by the court appears to require that the furtherance of the employer's business be the agent's primary motivation.[47]

While many courts use "beneficial purpose" as one factor in determining corporate liability for the acts and intent of

40. *E.g.*, Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982); C.I.T. Corp. v. United States, 150 F.2d 85 (9th Cir. 1945).

41. 307 F.2d 120 (5th Cir. 1962).

42. 15 U.S.C. §§ 715-715m (1982).

43. 307 F.2d at 127.

44. *Id.* at 128.

45. *Id.*

46. *Id.* at 128-29.

47. *Id.* at 127 (citing United States v. Armour & Co., 168 F.2d 342, 344 (3rd Cir. 1947)).

subordinate employees, it does not appear to be stringently applied as a limiting factor outside the Fifth Circuit.[48]

## IV. The Securities Exchange Act of 1934

### A. *Applicability of Common Law Agency Doctrines*

Both the Securities Act of 1933 [Securities Act] and the Securities Exchange Act of 1934 [Exchange Act] provide a statutory remedy akin to respondeat superior.[49] Section 20(a) of the Exchange Act imposes liability on any person who "directly or indirectly, controls any person" who violates the provisions of the Act.[50] Although Congress deliberately chose not to define the term "controlling person,"[51] there is some brief legislative history to section 20(a) which states that the term was "intended to include actual control as well as what has been called legally enforceable control . . . ."[52] Among the examples given in the legislative history of methods in which the control may be exercised are stock ownership, lease, contract, and agency.[53] This reference to agency has led some courts, notably those in the Third,[54]

48. Elkins, *supra* note 9, at 110. The "beneficial purpose" rule has been adhered to in another Fifth Circuit case, Steere Tank Lines, Inc. v. United States, 330 F.2d 719, 723 (5th Cir. 1969).

49. Section 15 of the Securities Act provides:

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

15 U.S.C. § 77(o) (1982).

50. Section 20(a) of the Act provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to 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.

15 U.S.C. § 78t(a) (1982).

51. Note, *"Controlling" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts*, 72 MINN. L. REV. 930, 932 (citing H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934)).

52. H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934).

53. *Id.*

54. *See* Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 884-86 (3d Cir. 1975); Thomas v. Duralite Co., 524 F.2d 577, 586 (3d Cir. 1975); *cf.* Sharp v. Coopers & Lybrand, 457 F.

Fourth,[55] and Ninth Circuits,[56] to the conclusion that the remedies provided by section 15 of the Securities Act and section 20(a) of the Exchange Act were intended to supplant common law agency doctrines.[57]

The Ninth Circuit seems the most dedicated to the proposition that section 20(a) supplants common law respondeat superior principles (unlike the Third and Fourth Circuits, it recognizes no broker-dealer exception). The more recent cases in the circuit use, with little additional analysis, the 1967 case *Kamen & Co. v. Paul H. Aschkar & Co.*[58] as support for its refusal to apply respondeat superior, calling this doctrine the "*Kamen rule*."[59] What is interesting is that the court of appeals in *Kamen* never reached this issue. The district court's finding of liability based upon respondeat superior was reversed, not because respondeat superior was held inapplicable, but because the lower court's finding of ostensible authority was "clearly erroneous."[60] By the higher court's effort in setting out the rules of respondeat superior and scrutinizing each element carefully, *Kamen* appears to implicitly sanction findings of liability under both common law agency doctrines and section 20(a).

The Ninth Circuit's resistance to the application of respondeat superior is curious in light of its eagerness to impose the same doctrine in the antitrust area. In *United States v. Hilton*

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Supp. 879, 890-92 (E.D. Pa. 1978) (agreeing that § 20(a) supplants respondeat superior generally, but finding exception for broker-dealers).

55. The position of the Fourth Circuit is somewhat ambiguous, but the doctrine of respondeat superior appears to have been rejected by the court in Carpenter v. Harris, Upham & Co., 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *accord*, Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303, 1309-13 (E.D. Va. 1981). *But see* Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1210-13 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124, 1130 (4th Cir. 1970).

56. *See* Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); Douglas v. Glen E. Hinton Investments, Inc., 440 F.2d 912, 914 (9th Cir. 1971); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438-39 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1210 (9th Cir. 1970); Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, *cert. dismissed*, 393 U.S. 801 (1968).

57. Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 884 (3d Cir. 1975) ("the principles of agency . . . are inappropriate to impose secondary liability in a securities violation case").

58. 382 F.2d 689, 697 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, *cert. dismissed*, 393 U.S. 801 (1968).

59. *See Zweig*, 521 F.2d at 1132.

60. *Kamen*, 382 F.2d at 696.

*Hotels Corp.*,[61] the circuit addressed the issue whether to impose corporate criminal liability under the Sherman Act based on the actions of corporate agents. Finding no mention of agency principles in the text of the statute, the court sought a construction of the Sherman Act which would best suit the Act's purpose. The language and subject matter of the Act dealt primarily with the activities of business entities.[62] The court determined that criminal liability for the acts of agents is more readily imposed when a statute is directed more at conduct than specific intent.[63] In enacting the Sherman Act, "Congress was passing drastic legislation to remedy a threatening danger to the public welfare . . . ."[64] In light of the "important public interests at stake," the court felt it reasonable to assume that Congress intended to impose liability upon business entities for the acts of their agents, "stimulating a maximum effort by owners and managers to assure adherence by such agents to the requirements of the Act."[65]

The United States Supreme Court affirmed the application of respondeat superior in civil antitrust actions in *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*[66] In that case, the Court stated that the liability of a principal based upon the acts of an employee cloaked with apparent authority had "long been the settled rule in the federal system."[67] The Court said further, "[i]n a wide variety of cases, the federal courts . . . have imposed liability upon principals for the misdeeds of agents acting with apparent authority."[68] One of the examples used by the Court to support the foregoing was a Sixth Circuit case which applied the doctrine of respondeat superior to

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61. 467 F.2d 1000 (9th Cir. 1972), *cert. denied*, 409 U.S. 1125 (1973).

62. *Id.* at 1004.

63. *Id.* at 1005.

64. *Id.* at 1005 (quoting United Mine Workers v. Coronado Coal Co., 259 U.S. 344, 392 (1922)). The court found that the statute

> was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.

*Id.* (quoting Northern Pacific Ry. v. United States, 356 U.S. 1, 4 (1958)).

65. *Id.*

66. 456 U.S. 556 (1982).

67. *Id.* at 567.

68. *Id.* at 568.

hold a corporation liable under section 12(2) of the Securities Act.[69]

Like the Sherman Act, the Exchange Act was Congress' response to a grave danger threatening the public welfare. The Act grew out of an investigation into stock market practices by the Senate Committee on Banking and Currency conducted between March 1932 and June 1934.[70] The report indicated that between September 1, 1929 and July 1, 1932 the total market value of stocks listed on the New York Stock Exchange dropped eighty-three percent from approximately $89 billion to approximately $15 billion.[71] The report described a number of abuses in the securities markets to which it attributed a large share of the responsibility for the stock market crash of 1929 and the resulting depression.[72]

In a House report by the Committee on Interstate and Foreign Commerce, the Committee interpreted a message to Congress by the newly inaugurated Franklin D. Roosevelt as making three important points.[73] First, the situation was bad and action was demanded. The action demanded was a requirement of "full and fair disclosure."[74] Second, while federal government requirements for disclosure should not be construed as guarantees of security issues, persons who "sponsor the investment of other people's money should be held up to high standards of trusteeship."[75] Third, honesty, care and competence were determined to be the demands of trusteeship.[76] The imposition of fiduciary standards of trusteeship connotes a broad liability on those dealing with the investing public. This broad-based liability demonstrates that the securities acts, like the Sherman Act, are an attempt to deal with certain practices and their consequences, not the intent of the wrongdoers.[77] In view of the focus and purposes of the securities acts, the common law principles of agency

69. *Id.* (citing Holloway v. Howerdd, 536 F.2d 690 (6th Cir. 1976)).

70. Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214, 217 (1959) (citing Senate Comm. on Banking and Currency, *Stock Exchange Practices*, S. REP. No. 1455, 73rd Cong., 2d Sess. (1934)).

71. *Id. at 217.*

72. *Id.*

73. Telly, *Proxies and the Modern Corporation: Scienter Under Sections 14a and 10b of the Securities Exchange Act*, 19 TULSA L.J. 491, 545-46 (1984) (citing H.R. REP. No. 85, 73d Cong., 1st Sess. 1-2 (1933)).

74. *Id.* (citing H.R. REP. No. 85, 73d Cong; 1st Sess. 1-2 (1933)).

75. *Id.*

76. Id. at 546-47.

77. *Id.* at 547.

should apply with force equal to that of other important statutory schemes designed to protect the public interest, absent any congressional intention to limit or supplant these doctrines. The Third Circuit's reluctance to apply common law agency doctrines to the securities acts concentrates on this issue of congressional intent. In *Rochez Brothers, Inc. v. Rhoades*,[78] the court determined that the use of respondeat superior would frustrate the intent of Congress in creating section 20(a).[79] The court reasoned that Congress intended liability to be based on culpable participation rather than control.[80] This conclusion was based on Congress' adoption of the House version of the bill, which called for a "fiduciary" standard, rather than the Senate version, which proposed a sort of "insurer's liability" standard.[81] The court felt that to apply respondeat superior would be to impose the insurer's liability standard rejected by Congress. The court argued:

> If we were to apply *respondeat superior* as appellant wishes, we would in essence impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they are dealing with their own corporate stock as individuals, and not for the corporation or for the benefit of the corporation. To impose such a duty would make the corporation primarily liable for any security law violation by any officer or employee of the corporation.[82]

Under the facts of *Rochez*, where a finding was made that the victim of the fraud knew the employee was acting outside of his scope of authority, the liability faced by the corporation would be that of insurer. The standards of respondeat superior do not, however, dictate such a result. The doctrine is applied only when the agent has the authority to act for the corporation, or where the corporation cloaks the agent with such apparent authority that others believe she is acting within that authority.[83] Properly applied, respondeat superior imposes no greater responsibility on corporations than that of a fiduciary.

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78. 527 F.2d 880 (3rd Cir. 1973).
79. *Id.* at 884.
80. *Id.* at 884-85.
81. *Id.* at 884.
82. *Id.* at 885.
83. *Id.* at 884. The court began its analysis with a correct statement of the law of respondeat superior:

> There is no doubt that the fraud of an officer of a corporation is imputed to the corporation when the officer's fraudulent conduct was (1) in the course of his employment, and (2) for the benefit of the corporation. This is true even if

The court in *Rochez* additionally determined that to apply respondeat superior would nullify the "good faith exception" found within section 20(a).[84] Such nullification, however, is only partial. Section 20(a) refers to persons who "directly or indirectly" control those liable.[85] Section 20(a) uses the term "person" broadly, including individuals, organizations, and groups. Congress, noting that it was "difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exercised," intentionally failed to explicitly define controlling person.[86] Congress believed that it could not predict every potential way in which a person may be controlled and decided to let the courts develop the appropriate guidelines.[87] While there have been a great many cases where control person liability has arisen in the context of an employer-employee relationship,[88] there is general agreement among the courts that the means of control need not necessarily derive from traditional employer-employee or principal-agent relationships.[89]

With the broad scope of the controlling person provisions of both acts, nullification of the good faith defense of section 20(a) is far from complete. The good faith defense was not a part of the original bill; it was added as a response to the tremendous criticism and lobbying of the securities industry to the Exchange

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> the officer's conduct was unauthorized, effected for his own benefit but clothed with apparent authority of the corporation, or contrary to instructions. The underlying reason is that a corporation can speak and act only through its agents and so must be accountable for any acts committed by one of its agents within his actual or apparent scope of authority and while transacting corporate business.

*Id.* Since the court found that no actual or apparent authority existed in this case, the rest of the opinion refusing to apply respondeat superior to securities violations is arguably dicta.

84. *Id.* at 885.

85. Note, *supra* note 51, at 931 (citing 15 U.S.C. § 78t(a) (1982)).

86. *Id.*, at 932 & n.8 (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934)).

87. *Id.*

88. Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 Wash. & Lee L. Rev. 1007, 1011 (1983); *see, e.g.*, Henricksen v. Henricksen, 640 F.2d 880, 884 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); Sharp v. Coopers & Lybrand, 649 F.2d 175, 179 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

89. Ferrara & Sanger, *supra* note 88 at 1011; *see* Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394 (4th Cir.), *cert. denied*, Carpenter v. Edwards & Warren, 444 U.S. 868 (1979); Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W.D. Ark. 1949).

Act.[90] It seems most likely that the "good faith" exception was not created to relieve corporations of the burdens of respondeat superior, but to relieve the burdens of additional vicarious liability imposed by the bill.

Moreover, corporations are creatures of state law. In the field of federal securities regulation, "congressional regulation is generally enacted against the background of existing state law; Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute."[91] Not only is there no express intent shown in the Exchange Act to supplant state corporate or common law principles, section 28 of the Act expressly provides, "The rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . ."[92]

Even in those courts which have determined that respondeat superior is inapplicable under the Exchange Act, the corporate knowledge doctrine should not be excluded, despite being an agency principle. First, the doctrine of corporate knowledge is used in many cases to support a finding of *primary*, rather than *secondary*, liability. The principle of corporate knowledge can act independently of respondeat superior in cases where the possessor of the knowledge is not the corporate actor in a challenged transaction. Moreover, in all cases where a corporation has committed securities fraud against a third party, imputation of scienter to the corporation as an element of 10b-5 is a prerequisite to finding secondary liability on the part of its officers or directors.[93]

Also, if the courts which disallow agency principles in finding secondary securities violations were taken at their word, a

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90. Ferrara & Sanger, *supra* note 88, at 1009; *see* 77 CONG. REC. 8924 (1934).

91. Burks v. Lasker, 441 U.S. 471, 478 (1979); *see* Cort v. Ash, 422 U.S. 66, 84 (1975); Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977); United Copper Sec. Co. v. Amalgamated Copper Co., 232 F. 574 (2d Cir. 1916); *cf.* United States v. Yazell, 382 U.S. 341, 352-53 (1966) (state family law); De Sylva v. Ballentine, 351 U.S. 570, 580 (1956) (state family law).

92. 15 U.S.C. § 78bb (1982). The section goes on to prohibit double recovery through application of more than one theory of recovery.

The Securities Act contains an analogous provision, section 16, which states: "The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 77p (1982).

93. *See* Cameron v. Outdoor Resorts of America, Inc., 611 F.2d 105, 107 (5th Cir. 1980) (remanding cause for finding of corporate scienter to determine if president of corporation could be found liable as controlling person).

corporation could never be found secondarily liable. Though the courts have divided on this issue, those circuits which hold section 20(a) as supplanting common law agency principles generally agree that to impose liability under the controlling person provisions, the controlling person must intentionally participate in the fraud.[94] As a corporation has no knowledge other than that imputed to it by its agents, a disallowance of imputed knowledge would effectively preclude a corporation from ever being found secondarily liable.

### B. *Aggregation of Knowledge*

In assessing the state of mind of a corporation as to a challenged transaction, courts have divided on the issue of whether the knowledge of all employees may be aggregated, or whether one single employee must possess a culpable state of mind. The split seems to depend neither upon the circuit deciding the matter nor upon the subject matter of the lawsuit. No court has squarely faced the issue as it applies to scienter under the Exchange Act.

The issue has, however, arisen in actions relating to scienter under common law fraud. For example, in a recent case, *First Equity Corp. v. Standard & Poor's Corp.*,[95] the purchaser of bonds who relied upon the description of the bonds given in a Standard & Poor's publication suffered losses as a result of certain misstatements in the publication. Alleging common-law fraud, the plaintiff attempted to show scienter[96] by attributing

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94. The First, Second, Third, Fourth, Sixth, Seventh, and Ninth Circuits generally agree that intentional participation is required to impose secondary liability under section 20(a). *See* Kersh v. General Council of Assemblies of God, 804 F.2d 546, 549 (9th Cir. 1986); Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 485 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); Carpenter v. Harris, Upham & Co., 594 F.2d 388, 395 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976); SEC v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Sennott v. Rodman & Renshaw, 474 F.2d 32, 39-40 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp 203, 212-13 (D. Mass. 1978).

The Fifth, Eighth, and Tenth Circuits generally agree that once a defendant is shown to occupy a position of control, the burden is shifted to the defendant to show an exercise of diligence and due care, suggesting a mere negligence standard. *See* Cameron v. Outdoor Resorts of America., 608 F.2d 187, 194-95 (5th Cir. 1979); Delporte v. Shearson, Hammill & Co., 548 F.2d 1149, 1154 (5th Cir. 1977) (per curiam); Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985, *cert. denied*, 474 U.S. 1057, 1072-73 (1986); Richardson v. MacArthur, 451 F.2d 35, 41-42 (10th Cir. 1971).

95. 690 F. Supp. 256 (S.D.N.Y. 1988), *aff'd*, 869 F2d 175 (2d Cir. 1989).

96. *Id.* at 259. The court held that to show scienter, the plaintiffs had to demon-

to Standard & Poor's the combined knowledge of several of its employees. The court, while acknowledging that a corporation may be charged with the knowledge of its employees, held that in order for a corporation to have a culpable state of mind, that state of mind must be possessed by a single individual.[97]

The opposing view was held in the Ninth Circuit case of *W.R. Grace & Co. v. Western U.S. Industries*.[98] In *Grace*, a corporation had previously sought a patent on its design of a custom wheel, claiming that the wheel's success was due to its unique design and not due to extensive advertising. As part of the application, the president of a subsidiary company submitted an affidavit stating that the only publicity for the wheel consisted of a single advertisement. In reality, the wheel had received much more extensive advertising. In finding the corporation had scienter[99] in making the false statement, the court stated that even if the president himself had no doubts about the truth of his affidavit,[100] someone in the company must have known about the extensive advertising; since the knowledge of the affidavit and the advertising could both be imputed to the corporation, the court determined the corporation acted with scienter and sustained the district court's finding that the corporation had committed fraud in its application for a patent.[101]

The approach of the court in *Grace* appears to be more consistently followed.[102] The approach is based on the notion that a

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strate that the statements were made with actual knowledge of their falsity, or with reckless disregard of the truth or falsity. The court stated that "[t]o show reckless disregard, '[t]here must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the truth of his publication.' " *Id.* (quoting St. Amant v. Thompson, 390 U.S. 727, 731 (1968)).

97. *Id.* at 260. In making this determination, the court relied on a Ninth Circuit decision, Kern Oil & Refining Co. v. Tenneco Oil Co., 792 F.2d 1380, 1386-87 (9th Cir. 1986), *cert. denied*, 480 U.S. 906 (1987). The relevant issue in *Kern* was whether Kern Oil had knowledge of a price change regarding oil it was purchasing such that it was estopped from later claiming a refund for alleged overpayments. The legal department of Kern Oil did not know of the price change, and the accounting department (who did know of the price change) did not know that such a change was improper. In holding that the corporation could not be charged with the collective knowledge of the two departments, the court found that the overpayments were a mistake of law and allowed recovery of the excess.

98. 608 F.2d 1214 (9th Cir. 1979), *cert. denied*, 446 U.S. 953 (1980).

99. The court had defined scienter as a "calculated recklessness about the truth." *Id.* at 1218 (quoting Monolith Portland Midwest Co. v. Kaiser Aluminum & Chem., 407 F.2d 288, 297 (9th Cir. 1969)).

100. The Court stated that this assumption was "dubious." *Id.* at 1219.

101. *Id.*

102. *See, e.g.*, United States v. T.I.M.E.-D.C., Inc., 381 F. Supp. 730 (W.D. Va.

corporation should not be able to escape liability by restricting the intracorporate flow of information.[103] This approach best serves the purposes of the Exchange Act. The securities acts were designed to eliminate abuses in the securities industry by substituting "a philosophy of full disclosure for a philosophy of caveat emptor."[104] This requirement of "full and fair disclosure"[105] would be seriously compromised if corporations were "rewarded" by avoiding liability through faulty communication lines. It is well established that "conscious ignorance" is legally equivalent to knowledge.[106] A requirement that corporate liability may lie only where all culpable knowledge exists in a single individual would allow a corporation to engage freely in conscious ignorance by keeping lines of communication between different departments closed. Admittedly, "the diverseness of a corporate enterprise makes it very possible for the right hand not to know what the left knows;" nonetheless that is one of the risks a large enterprise takes.[107]

### C. *Limitations on the Imputation of Scienter*

#### 1. *Officers and directors*

*a. Personal interest and constructive fraud in shareholder derivative suits.* The most important limit placed on the imputation of knowledge to a corporation operates in cases where the

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1974); Riss & Co. v. United States, 262 F.2d 245 (8th Cir. 1958); Inland Freight Lines v. United States, 191 F.2d 313 (10th Cir. 1951); United States v. Sawyer Transport, Inc., 337 F. Supp. 29 (D. Minn. 1971), *aff'd.*, 463 F.2d 175 (8th Cir. 1972).

103. W. FLETCHER, *supra* note 3, at § 790.

104. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

105. H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

106. *E.g.*, Wecker v. Nat'l Enameling & Stamping Co., 204 U.S. 176 (1907); United States v. Ciampaglia, 628 F.2d 632, 643, *cert. denied*, 449 U.S. 956 (1980); Hertzmark v. Lynch, 54 F.2d 38 (1st Cir. 1931), *cert. denied*, 287 U.S. 605 (1932).

107. Equitable Trust Co. v. G & M Constr. Co., 544 F. Supp 736, 744 (D. Md. 1982). Moreover, the type of risk taken by a large corporation is, in many instances, different from the risk taken by those dealing with it.

For example, in Harris v. Lewis State Bank, 436 So. 2d 338 (Fla. App. 1983), a failure of communication resulted in an unlawful arrest. In that case, a woman, semi-literate and crippled from a bout with polio, received a bank statement bearing her name and a name of a stranger. She asked a teller at the bank about the statement, and was told that someone must have put the money in the account for her. She was given an identification card to facilitate withdrawals from the account and was allowed to take money out. The real owner of the account discovered the money missing and contacted the police. When the woman tried to make a further withdrawal, the bank guard detained her and had her arrested. In holding that the bank could be held liable for false imprisonment, the court imputed the knowledge of the teller to the bank, who acted through its guard. *Id.* at 341.

directors possess a personal interest adverse to their own corporation. This "personal interest" exception is stated as follows:

> [W]hen an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, the presumption that knowledge held by the agent was disclosed to the principal fails because he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose.[108]

Were there no personal interest limitation, the corporation would always be deemed to possess the knowledge of the directors acting adversely and thus could never be deceived by them.

The personal interest limitation is of greater importance in the securities area following the Supreme Courts's decision in *Santa Fe Industries, Inc. v. Green.*[109] Prior to the Court's decision in *Green*, a number of the circuits held that a breach of fiduciary duty would give rise to a cause of action under Rule 10b-5, if the breach occurred in connection with the purchase or sale of a security.[110] The Court in *Green* held that a breach of fiduciary duty does not give rise to a cause of action under 10b-5 absent some showing of deception. The decision left unanswered the question of what constitutes deception in the breach of duty context.[111]

In determining whether a corporation has been deceived, many courts rely on the "constructive fraud" doctrine.[112] Under agency law principles, the knowledge of a director is not imputed to the corporation when her interests conflict with those of the corporation.[113] The corporation can thus be deceived if a self-dealing director misrepresents or fails to disclose material facts to a majority of the board of directors.[114] If the act of a director or directors is approved by a majority of disinterested

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108. Center v. Hampton Affiliates, Inc., 66 N.Y.2d 782, 497 N.Y.S.2d 898, 899-900, 488 N.E.2d 828, 829-30 (1985).

109. 430 U.S. 462, 474 (1977).

110. *See, e.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 378-79 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973); Dasho v. Susquehanna Corp., 461 F.2d 11, 32 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972).

111. Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After* Santa Fe Industries, Inc. v. Green, 91 HARV. L. REV. 1874 (1978).

112. *See* Klamberg v. Roth, 473 F. Supp. 544, 550-51 (S.D.N.Y. 1979) (memorandum).

113. W. FLETCHER, *supra* note 3, at § 819.

114. Dasho v. Susquehanna Corp., 461 F.2d 11, 26 (7th Cir. 1972), *cert. denied*, 408 U.S. 925 (1972); Ruckle v. Roto American Corp., 339 F.2d 24, 25 (2d Cir. 1964).

directors, however, there is no deception of the corporation. The constructive fraud doctrine comes into play when a majority of the board of directors have an interest in a transaction and fail to disclose material information concerning the transaction to the shareholders. In such instances the minority shareholders themselves become the repository of the corporation's capacity to be deceived.[115]

In *Maldonado v. Flynn*,[116] the Second Circuit established standards for determining when a director has a conflict of interest sufficient to limit the imputation of knowledge through her. In *Maldonado*, certain key employees of Zapata Corporation were the recipients of a stock option plan. Prior to the exercise date of the options, the corporation decided to make a cash tender offer in the open market for its own stock.[117] The offer was to be for a price which was substantially in excess of the market price of the stock.[118] In contemplation of the effect the tender offer would have on the price of Zapata stock, the stock plan was amended prior to the announcement of the offer to allow the immediate exercise of the options. In addition, the corporation provided the key employees with interest-free loans to facilitate the exercise. The effect of the accelerated exercise was to transfer certain tax advantages from the corporation to the directors.[119] A derivative suit was filed against the directors under Rule 10b-5, alleging that the corporation was deceived by the board's failure to disclose the changes to the stock plans.[120]

The court of appeals affirmed the district court's dismissal of the plaintiffs' 10(b) claim.[121] The court of appeals, in holding that the corporation was not deceived, found that a disinterested majority of the board of directors had previously approved the

115. Note, *supra* note 111, at 1882; *see, e.g.*, Dasho v. Susquehanna Corp., 461 F.2d 11, 26 (7th cir.), *cert. denied*, 408 U.S. 925 (1972); Pappas v. Moss, 393 F.2d 865, 869 (3d Cir. 1968). In such conflict of interest situations, the majority shareholders are associated with the board of directors which they elected.

116. 597 F.2d 789 (1979).

117. *Id.* at 791. Zapata stock was traded on the New York Stock Exchange. *Id.* n.3.

118. 597 F.2d at 791.

119. *Id.* at 792.

120. The complaint also alleged violation of § 14, 15 U.S.C. § 78n(a), and Rule 14a-9 by making statements in proxy solicitations issued to the shareholders by the corporation for the election of directors that were misleading with respect to the stock option plans. 597 F.2d at 790-91. The court of appeals reversed the district court's dismissal of the complaint and remanded the case for further proceedings. *Id.* at 798.

121. 597 F.2d at 791.

modification of the option plan.[122] The court adopted the rule that for a director to be deemed "disinterested," the person must have "no material personal interest in the transaction or matter under consideration."[123] The "personal interest" was required to be pecuniary.[124] While the court did not set out clearly at what point a director develops an interest adverse to the corporation, the court did consider the possible interest of one director.

One of the directors voting for the proposed option modification plan was a partner in a large law firm which annually received substantial funds from Zapata.[125] While admitting that such a relationship could well have motivated the director to curry favor with some of the beneficiaries of the plan, the court held that absent some claim that his vote was exchanged *quid pro quo* for the firm's continued representation of Zapata, labeling him as an interested director would "open the door to an unworkable standard for determining whether there has been deception practiced upon the corporation."[126] The court reasoned that so long as laws permitted outside counsel to serve as corporate directors, it could not assume such a relationship gives rise to an adverse interest.[127] In addition, the court presumed that since the shareholders were aware of the director's relationship as outside counsel when he was elected, the shareholders were willing to trust his independent judgment.[128]

In addition to its analysis of what constitutes an adverse interest, the court reaffirmed the rule that dominion or control by those who benefit from an action by the board will preclude the remaining directors from being disinterested.[129] The court rea-

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122. *Id.* at 793.

123. *Id.* at 795.

124. *Id.* at 793.

125. *Id.* at 794. During the fiscal year in which the challenged transaction took place, the law firm received over $960,000 in fees. *Id.* n.7.

126. 597 F.2d at 794.

127. *Id.*

128. *Id.* Another director who voted to approve the option plan was engaged in a private scheme to profit from inside information concerning the tender offer. The plaintiffs argued that such improper conduct tainted his judgment such that he could not be considered "disinterested." The court agreed this director's conduct might have influenced him to vote for the proposed modification in order to protect himself from the judgment of the other directors should his self-dealing be uncovered. The court, however, found it unnecessary to reach a conclusion regarding his possible adverse interest as, even without his vote, a disinterested majority approving the plan still existed. *Id.*

129. *Id.* at 795.

soned in such cases the knowledge of the controlled directors could not be imputed to the corporation or its stockholders, since the directors would be acting as mere "pawns" of the controlling wrongdoer.[130] The court in *Maldonado* found no such control.[131]

The *Maldonado* court's requirement that an interest must be material and pecuniary seems to be consistent with a number of other decisions.[132] For example, in *Tyco Laboratories, Inc. v. Kimball,*[133] the District Court for the Eastern District of Pennsylvania held that the mere desire of directors to perpetuate their membership on the board and control the corporation was not a strong enough personal interest to require disclosure to the shareholders.

The issue whether legal fees paid to outside counsel serving as a director constitutes a personal interest was further refined in a pair of district court cases. In *Bolton v. Gramlich,*[134] the court found that a trustee, serving as outside counsel, had a financial interest in a challenged liquidation and sale. The court distinguished *Maldonado* as follows:

> [I]n *Maldonado*, the plaintiffs had merely alleged that the defendant lawyer's position as the corporation's lawyer may have 'motivated him to curry favor' with the interested parties. The lack of any specific benefit that could run to him if he voted in a particular way left him disinterested. In [the present case],the legal fees that would result from the sale and termination supply the specific interest that was lacking in *Maldonado.*[135]

Thus in *Bolton*, the court drew the distinction between the indirect benefit of ensuring legal fees through currying favor with the customer corporation and the direct benefit of obtaining fees as a result of the transaction itself. This distinction was likewise made in *Terrydale Liquidating Trust v. Barness,*[136] where the court found that when a trustee, serving as outside

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130. *Id.* (citing Goldberg v. Meridor, 567 F.2d 209, 217 (2d Cir. 1977)).

131. *Id.*

132. *See, e.g.*, Bolton v. Gramlich, 540 F. Supp. 822 (S.D.N.Y. 1982); Falkenberg v. Baldwin, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,086a (S.D.N.Y. 1977); Tyco Laboratories, Inc. v. Kimball, 444 F. Supp. 292 (E.D. Pa. 1977).

133. 444 F. Supp. 292, 297 (E.D. Pa. 1977).

134. 540 F. Supp. 822 (S.D.N.Y. 1982).

135. *Id.* at 838.

136. 611 F. Supp. 1006 (S.D.N.Y. 1984).

counsel, stood to gain legal fees only if a certain transaction took place, an issue of fact existed as to his self-interest.[137]

Is the personal interest requirement established and followed by the Second Circuit sound? Certainly the continued receipt of approximately $1 million in annual legal fees[138] is just as great an incentive for exercising self-interest as the fees generated in a single transaction. Likewise, the desire for retained control of a corporation may be a greater incentive than direct, pecuniary interests.[139]

Despite the possibility of foreclosing otherwise meritorious shareholder derivative suits,[140] a bright line test for cutting off the knowledge of the directors to the corporation is appropriate. Even those critical of extended criminal liability in the corporate setting generally have little problem with imputing the intent of the directors to the corporation.[141] The perceived injustice of punishing the shareholders for decisions made by subordinate employees over whom the shareholders have no direct control is not present when liability is imposed upon directors. The shareholders elect the directors; they have a direct impact on the mind and actions of the corporation by their choices.[142] The types of indirect or nonfinancial interests found by the courts to be insufficient to block the imputation of knowledge to corporations, *i.e.*, the desire to retain control and lawyer-client relationships, are interests which tend to be ongoing and should be ascertainable by the shareholders when elections are held. A lesser rule would allow shareholders to challenge virtually any breach-of-duty as deception, thus abrogating the Supreme Court's ruling in *Santa Fe*.

*b. Dealings with third parties—the benefit test.* In *Cenco, Inc. v. Seidman & Seidman*,[143] a scheme to artificially inflate the stock price of a corporation to obtain other companies and loans was undertaken by the company's chairman and president, along with a number of vice-presidents and top managers. An indepen-

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137. *Id.* at 1021-22. *But cf.* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.) (no inference of self-interest drawn when target company director's investment banking firm performed the work for company), *cert. denied*, 454 U.S. 1092 (1981).

138. *See supra* note 125.

139. Sherrard, *Federal Judicial and Regulatory Responses to* Santa Fe Industries, Inc. v. Green, 35 WASH. & LEE L. REV. 695, 712 (1978).

140. *Id.*

141. *See* Mueller, *supra* note 30, at 40.

142. *Id.* at 40-41.

143. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

dent auditing firm which negligently failed to discover the fraud was named, along with the corporation itself, in a class action suit by the corporation's shareholders. In upholding the dismissal of the corporation's crossclaim against the accounting firm, the court held that the fraud in the case was attributable to the corporation and that third party negligence was not a defense to fraud.[144]

In determining whether to attribute the knowledge of the chairman and officers to the corporation, the court determined that a greater deterrence would result by holding the corporation, as opposed to the negligent accountants, liable to defrauded third parties.[145] In making this determination, the court chose to place responsibility on the shareholders.[146]

The court, however, rejected the idea that fraud by employees should always be attributed to a corporation.[147] The court cited the Illinois Court of Appeals case *Cereal Byproducts Co. v. Hall*,[148] which held an independent auditor negligent in failing to detect embezzlement by a corporation's bookkeeper, rejecting the auditor's attempt to impute the bookkeeper's actions to the corporation. The court in *Cenco* distinguished *Cereal Byproducts* by noting a difference between fraud against a corporation and fraud in behalf of it.[149] The important difference is when fraud is committed on behalf of a corporation the shareholders are the beneficiaries of the fraud.[150] The court found unimpor-

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144. *Id.* at 456. The court expressly refused to reach the issue of whether the fraud of any employee, no matter how lowly, would be attributable to the corporation. *Id.*

145. *Id.* at 455.

146. The court reasoned:

> Cenco's owners—the stockholders—hired managers (directly, in the case of the president and chairman, who were both members of the board of directors, indirectly in the case of the others) who turned out to be thoroughly corrupt and to corrupt the corporation so thoroughly that it caused widespread harm to outsiders. If [the accountant] had been a more diligent auditor, conceivably if it had been a more honest auditor, the fraud might have been nipped in the bud; and liability to Cenco would make [the accountant] and firms like it, more diligent and honest in the future. But if the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced.

686 F.2d at 455.

147. *Id.*

148. 8 Ill. App. 2d 331, 132 N.E.2d 27 (1956).

149. 686 F.2d at 456.

150. *Id.*

tant that the unmasking of the fraud created a net detriment to Cenco.[151]

The particular facts in *Cenco* raise the issue of motive. It is clear from the opinion that a purpose to benefit the corporation would allow insiders' knowledge to be attributed to the corporation. Less clear is whether the "benefit" limitation requires that the benefit to the corporation be the primary goal, as opposed to simply an incidental, but foreseeable, result.

The court in *In re Wedtech Corp.*,[152] in a situation similar to that in *Cenco*, took a somewhat stronger view and adopted what it referred to as an "adverse interest" exception to the general imputation rule:

> To come within the exception, the agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict or because he is not acting primarily for his principal.[153]

In actuality, the *Cenco* "benefit" test and the *Wedtech* "adverse interest" test are two sides of the same coin. In the *Cenco* case, those involved in the scheme owned large quantities of the corporation's stock.[154] It is likely that the corrupt insiders were acting primarily in their own interest—indifferent to the long-term benefit or detriment to the company. The *Cenco-Wedtech* approach thus differs from the "beneficial purpose" test enunciated in *Standard Oil*, which appeared to require that the purpose to benefit the employer be the primary motivation.[155]

The *Cenco-Wedtech* approach likewise differs from the "personal interest" test as applied by the court in *Maldonado*. Were the "personal interest" test applied to the facts of *Cenco*, the personal interests of the insiders may have prevented the imputation of the fraud to the corporation. This difference in approaches is appropriate. While the "personal interest" test works well in situations where officers and directors are defrauding their own corporation, an entirely different situation exists when these insiders use the corporation to defraud outsiders (creditors, prospective stockholders, insurers, etc.). In cases

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151. *Id.*

152. 81 B.R. 240 (S.D.N.Y. 1987).

153. *Id.* at 242 (quoting Center v. Hampton Affiliates, Inc., 66 N.Y.2d 782, 497 N.Y.S.2d 898, 899-900, 488 N.E.2d 828, 829-30 (1985)).

154. *Id.* at 455.

155. *See supra* text accompanying notes 40-48.

where the "insiders" defraud the corporation itself, the personal interest test strikes a balance which holds the shareholders responsible for their choices of directors (and indirectly officers and managers)[156] and allows shareholders to pursue a cause of action for deceit in cases where unanticipated conflicts of interest arise. In cases where outsiders are the victims, greater responsibility on the part of the shareholders is called for. This is especially true when the misdeeds perpetrated benefit the corporation.

### 2. *Subordinate employees*

While the court in *Cenco* found no difficulty in imputing the knowledge of officers, directors, and managers to the corporation using the "benefit test" as a limit, the court expressly left open the question of whether the fraud of a low-level employee could be attributed to the corporation.[157]

*a. Linkage requirement.* The linkage requirement, mentioned above in the section on corporate criminal liability,[158] dictates that in order to impute the intent of a subordinate employee to the corporation, a "link" must be established showing that some member of the "inner circle"[159] had either actual or constructive knowledge of the acts of the subordinate.[160] The main difficulty with the linkage requirement is that a "link" may be difficult to establish absent a consistent pattern of wrongdoing.[161]

This requirement applied to the Exchange Act could seriously frustrate enforcement of key provisions. For example, Rule 10b-5 provides in part that "[i]t shall be unlawful for any person, directly or indirectly . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[162] The linkage requirement would impose liability where the "practice" or "course of business" consists of fraudulent or deceitful acts themselves. The linkage re-

156. Professor Mueller gave credence to the argument that officers and other high managerial agents are many times known by the shareholders and subject to their scrutiny, whether elected or appointed. Mueller, *supra* note 30, at 40-41.

157. *Cenco*, 686 F.2d at 456.

158. *See supra* text accompanying notes 28-36.

159. *See supra* text accompanying note 33.

160. *See supra* text accompanying note 35.

161. *See* Elkins, *supra* note 9, at 110.

162. 17 C.F.R. § 240.10b-5 (1989).

quirement would not, however, be sufficient to establish liability on a corporation where the "practice" or "course of business" which acts as a fraud consists of a system of preserving the ignorance of members of the "inner circle." This ignorance could be accomplished in one of two ways. First, superiors could convey to employees the understanding that they do not want to hear information which could subject the corporation to liability.[163] Second, the superiors could delegate full responsibility for those activities which might result in violations.[164]

b. *Breach of a stringent duty to supervise.* In determining whether to impose liability under the Exchange Act using the doctrine of respondeat superior, several courts have looked to whether a stringent duty to supervise existed.[165] These courts have, however, disagreed on the application of the doctrine where such a duty exists. In *Marbury Management, Inc. v. Kohn,*[166] the Second Circuit held a brokerage house liable for the fraudulent conduct of a trainee in its employ. Noting that a stringent duty to supervise existed in the brokerage house setting, the court imposed liability irrespective of whether this duty was found to be breached.[167]

The Third Circuit in *Sharp v. Coopers & Lybrand,*[168] took a similar approach in finding a stringent duty to supervise sufficient for applying the doctrine of respondeat superior against an accounting firm for the misdeeds of a subordinate employee. Noting that protection of the public is the primary purpose of the securities laws, the court concluded that the representations of accounting firms are designed to influence the investing public.[169] The court reasoned that failure to apply the doctrine of respondeat superior would allow the firm to immunize itself from liability by erecting a shield between employees and partners and delegating the writing of opinions to the former.[170] In

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163. Note, *Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1254 (1979).

164. *Id.*

165. *See* Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981).

166. 629 F.2d 705 (2d Cir.), *cert denied*, 449 U.S. 1011 (1980).

167. *Id.* at 716 ("Here the concern is simply with scope or course of employment and whether the acts of the employee . . . can fairly be considered to be within the scope of his employment.").

168. 649 F.2d 175 (3d Cir. 1981).

169. *Id.* at 184.

170. *Id.*

concluding its analysis, the court made the statement that a firm's "failure to perform [its] duty will expose it to liability for their violations of Rule 10b-5 under the doctrine of respondeat superior."[171] This statement, taken at face value, appears to confuse negligence with respondeat superior. Its implication is that if a defendant principal shows that it met its duty to supervise, it may avoid secondary liability.

Is such a limitation sensible? Professor Mueller would have agreed that it is. He admitted that an argument could be made that a corporation standing to profit from the criminal acts of its employees may be tempted into giving sub rosa encouragement of such behavior and, despite such encouragement, could still make a convincing case of due diligence.[172] His objection to this argument was that it punishes both innocent and guilty alike.[173] He felt it most unlikely that an employee could be induced to commit a crime for the benefit of the corporation, when the employee himself would be prosecuted.[174] In addition, he felt that the prevalence of sub rosa encouragement for violations by employees for the benefit of the corporation was grossly overstated.[175] The problem with this line of reasoning is that it assumes that an employee will seldom, if ever, intentionally violate the law to advance the interests of her employer absent some kind of encouragement, albeit sub rosa, on the part of management.

In instances where an employee can benefit herself, and incidentally the employer, through fraud or other illegal activity, there is no need for encouragement from the employer. Conversely, if the employee is benefitting the employer, there is little incentive for superiors to inform themselves as to the activities and intent of its subordinates, absent some form of vicarious liability.

c. *Rule 14e-3 and the policies and procedures exception.* There are portions of the Exchange Act where provision has been made for limiting the imputation of knowledge where diligence on the part of the corporation has been shown. For example, Rule 14e-3, which prohibits trading based on nonpublic information concerning tender offers, contains an express

171. *Id.* at 185.
172. Mueller, *supra* note 30, at 44.
173. *Id.* at 45.
174. *Id.*
175. *Id.*

exception for persons other than natural persons who implement policies and procedures to ensure against violations of the rule.[176] This exception does not, however, give credence to the idea that respondeat superior should not apply when a corporation has shown diligence in its supervision of subordinates.

Under 14e-3(b), the burden of proof is on the entity to prove that it qualifies for the exception.[177] To qualify the entity must show: First, that the individual decision maker(s) in the entity did not know the information at the time the investment decision was made;[178] and second, that the entity "has implemented one or a combination of policies and procedures, reasonable under the circumstances to ensure that individual(s) making investment decision(s) would not violate [the rule]."[179] By placing the burden of proof upon the entity to come under the exception, the rule presupposes that both the corporate knowledge doctrine and respondeat superior apply to employees of business entities and that no "breach of duty" prerequisite to their operation exists. If the entity meets its burden of proof, the exception operates to halt the operation of the corporate knowledge doctrine. The exception does not, however, halt the operation of the doctrine of respondeat superior.[180] In other words, the exception limits liability only in cases were the decision maker does not possess the nonpublic information concerning the tender offer; if the decision maker within the entity possesses the information at the time of the transaction, the entity will be held liable, along with the decision maker, regardless of whatever procedures were in place.[181]

*d. A reasonable limitation.* One question which should be asked is, whether there should be a limitation on the agency principles of corporate knowledge and respondeat superior. The *Hochfelder* requirement of scienter for finding Rule 10b-5 violations presents no greater difficulty for use of agency doctrines than does the requirement of mens rea in criminal statutes. Were no limits placed on these common law agency doctrines,

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176. 17 C.F.R. 240.14e-3(b)j (1989).

177. Exchange Act Release No. 17120 (Sept. 4, 1980) reprinted in Fed. Sec. Law Rep. (CCH) [Transfer Binder] p 82,646 (Sept. 4, 1980).

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

however, the corporation would arguably become the insurer of the conduct of its employees, the view rejected by Congress.[182]

The "linkage requirement" and "duty of supervision" limitations provide little incentive for superiors to discover fraudulent acts of employees which may, though incidentally, benefit the corporation. The *Cenco-Wedtech* "benefit" requirement for imputing both conduct and intent strikes a balance between making a corporation the insurer of its employees' conduct, and rewarding the employer for failing to discover an employee's fraudulent acts. The "benefit" requirement in this context does not require that an actual benefit be received, nor does the purpose to benefit the employer need to be the primary motivation. A good example of when an employee benefits the employer incidentally through deceptive conduct is when a securities broker "churns" a customer's account. Were the imputation of the act and intent of the employee not imputable to the brokerage house, there would be little incentive to discover such activities. On the other hand, when an employee's actions are such that all intent to benefit the employer is abandoned, there already exists adequate incentive for superiors to attempt to discover the improper actions.

### 3. *Outside expert agents*

In *Gillette Co. v. RB Partners*,[183] four directors of Gillette seeking reelection caused Gillette to enter into a proxy contest against the attempt of an outside partnership, the Coniston Group, to elect its own candidates. In its bid for votes, Gillette published an advertisement entitled "The Coniston Group—Who Are They?" The ad consisted of a flowchart showing the purported interests that various individuals, partnerships and banks had in Coniston.

In determining that Gillette violated Rule 14a-9, the court found the flowchart improperly exaggerated the role of foreign individuals and entities. In particular, the court held the placement of the various boxes (containing the names of the persons allegedly having an interest in Coniston), the size of the boxes, the thickness of the lines connecting the boxes, and the lack of a legend made the chart, as a whole, misleading.[184] Recognizing

182. *See* Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975).
183. 693 F. Supp. 1266 (D. Mass. 1988).
184. *Id.* at 1282.

that liability under 14a-9 could be based on either a knowing, reckless, or negligent misstatement, the court found the chart to be deliberately misleading.[185] In determining corporate state of mind, the court looked to all of the active agents, not just the chairman of the board.[186] The court, in addition to the state of mind of the employees of Gillette, attributed to the corporation the intent of the "expert agents" who prepared and published the ad.[187]

*Gillette* raises the issue of when may the scienter of an outside agent be imputed to a corporation. Under the general laws of agency, the acts and knowledge of independent contractors are not generally imputed to a principal who employs them.[188] The distinction between outside "agents" and "independent contractors" is not, however, always clear. One of the difficulties with the "linkage" requirement mentioned above is that, under the doctrine, corporations would be able to delegate important functions and disclaim the misdeeds of subordinates in relation to their performance of those functions. Similarly, a corporation may seek to disclaim scienter by delegating to outside agent/contractors the performance of functions which may influence investor decisions—specifically those functions performed by accounting firms, advertising agencies, and attorneys.

The case of *Spectrum Financial Co. v. Marconsult, Inc.*,[189] provides a good example of how an outside accounting firm may be encouraged to aid a corporation in defrauding investors. In that case, Marconsult, Inc. sought to issue common stock and convertible debentures to a group of limited partners in exchange for their interests in some oil and gas wells.[190] Pursuant to this anticipated transaction, Marconsult hired the accounting firm of Harris, Kerr, Forster and Company (HKF) to audit its financial condition and render an opinion for the previous calendar year. The twelve month statement was unfavorable. As a result it was not distributed to anyone outside Marconsult. The

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185. *Id.* at 1280. The court additionally found that if the ad were not deliberately misleading, it was negligently so. The court pointed out, however, that this was not its primary finding. *Id.* at 1281.

186. *Id.* at 1281.

187. *Id.*

188. Exceptions to this rule include nondelegable duties and ultrahazardous activities.

189. 608 F.2d 377 (9th Cir. 1979), *cert. denied*, 446 U.S. 936 (1980).

190. *Id.* at 379.

California Commission of Corporations, upon whose approval the agreement was conditioned, agreed to the exchange, but placed a legend on the stock which severely limited its transferability.

In view of the unfavorable twelve month financial statement, Marconsult requested that HKF prepare a new financial statement for a sixteen month period. This statement incorporated a large amount of business conducted during the four months prior to the beginning of the previous calendar year. As a result, it was considerably more favorable than the twelve month report. An opinion letter by HKF followed. Upon submission of the sixteen month report,[191] the Commissioner removed the restrictions on the stock.

Approximately ten months after the exchange was completed, Marconsult became virtually insolvent. Suit was filed against both Marconsult and its accountant under Rule 10b-5. The district court granted summary judgment in favor of HKF. The court of appeals reversed, finding triable issues of fact with respect to HKF's possible 10b-5 violations.[192] In making this determination, the court looked extensively into the possible motivations behind HKF's conduct as follows:

> HKF knew that a buyer had been found for what was essentially worthless stock. It also knew that without a buyer for its stock, Marconsult would not be in a position to pay HKF's fee. HKF's strong incentive to make Marconsult "look good" on paper created a relationship with any potential buyer not unlike the relationship in *[Zweig v. Hearst Corp.*[193]] where a financial columnist had a strong incentive to make a particular merger appear attractive to his readers.[194]

Although it was unnecessary to impute the scienter of the accounting firm to the corporation in *Spectrum*, the facts demonstrate the potential for sub rosa encouragement of misconduct by outside experts. While it may seem that the situation would seldom arise where an outside agent will be secretly encouraged to aid corporate fraud, it is less likely that an outside agent would do so without such encouragement. For this reason, the *Cenco-Wedtech* "benefit" rule, discussed above in relation to

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191. The 12 month report was never given to the Commission.
192. *Id.* at 382.
193. 594 F.2d 1261 (9th Cir. 1979).
194. 608 F.2d at 381.

the scienter of employees, applied to impute the scienter of an outside expert to the corporation would act to provide a great benefit to plaintiffs in proving scienter with little risk of injustice to corporate defendants.

## V. Conclusion

Though the principles of corporate knowledge and respondeat superior are rooted in common-law agency doctrines, they have been employed in various forms to statutory violations which require a mental element for liability. While early courts were reluctant to impose liability on corporations for criminal violations requiring a mental state for liability, later courts have recognized the great deterrent effect such sanctions afford. As corporations can act only through their agents, imputation of intent through agency doctrines is necessary. The requirement of scienter for certain antifraud provisions of the Exchange Act should have no effect on how scienter for corporations is determined. Courts have proposed various theories for limiting the application of agency principles in situations involving intent. The limiting theory used should take into account the purpose of the substantive law at issue.

The antifraud provisions of the Exchange Act were enacted to protect the public against misrepresentations and other deceptive practices in securities transactions, but were not intended to hold corporations to the duty of an insurer. In situations where officers and directors are accused of mismanagement, a bright line test is needed to effectuate the deception requirement of section 10(b) enunciated by the United States Supreme Court in *Green*.[195] Limiting the imputation of knowledge to the corporation when directors have a direct, pecuniary interest in a challenged transaction meets this need while allowing shareholders a cause of action in cases where unknown conflicts may have influenced members of the inner circle to act detrimentally to the corporation. In dealings with third parties, imputing to a corporation the acts and intents of those agents benefiting the corporation will provide additional incentive for enterprises to be self-policing without holding them strictly liable for every act of a subordinate.

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195. 430 U.S. 462 (1977).