Elusive Standard to Plead §20(a) Control Person Liability

Practitioners might reasonably assume that the standard for pleading control person liability under §20(a) of the Securities Exchange Act of 1934—a provision unchanged since its enactment—is well-established.

Section 20(a) provides that a person who controls another person found liable for securities fraud under the Exchange Act is jointly and severally liable, “unless the controlling person acted in good faith and did not directly or indirectly induce” the violation. 15 USC §78t. In the U.S. Court of Appeals for the Second Circuit, however, the standard is anything but clear.

The Court of Appeals has laid out a test, but its application has taken almost as many divergent interpretations as there are judges win the U.S. District Court for the Southern District of New York.

All agree that a plaintiff must plead at least two elements: a primary securities fraud violation and control of the primary violator. The courts in the circuit are divided, however, on: (1) whether a plaintiff also must plead the controlling person’s “culpable participation in the fraud” and (2) if so, exactly what this entails—scienter, thus requiring heightened pleading under the Private Securities Litigation Reform Act (PSLRA), or something less.

In the latest decision on the issue, Lapin v. Goldman Sachs Group, Inc., No. 04-2236, 2006 WL 2850226, at *19 (SDNY Sept. 29, 2006), the judge held that a plaintiff must plead the controlling person’s culpable participation in the underlying fraud, and must satisfy the PSLRA by alleging “at a minimum, particularized facts of the controlling person’s conscious misbehavior.” The Lapin opinion thus furthers the dichotomies within the Second Circuit, but is consistent with the precedent of the Court of Appeals and represents the majority—and the prudent—approach to pleading a §20(a) claim in this circuit.


culpable participation’ Element

The words “culpable participation” are not in §20(a). In 1973, the Second Circuit considered the extent of a director’s duties under Rule 10b-5, and control of the primary violator. The courts in the circuit are divided, however, on: (1) whether a plaintiff also must plead the controlling person’s “culpable participation in the fraud” and (2) if so, exactly what this entails—scienter, thus requiring heightened pleading under the Private Securities Litigation Reform Act (PSLRA), or something less.

In ‘Lapin,’ the judge said a plaintiff must plead the controlling person’s culpable participation in the underlying fraud, and must satisfy the PSLRA by alleging, at minimum, facts of that person’s conscious misbehavior.

With respect to a stock sale by management, Lanza v. Drexel & Co., 479 F2d 1277, 1279 (2d Cir. 1973) (en banc). Although no §20(a) claim was before it, the court analyzed common law and the Exchange Act in full, and stated that “[the intent of Congress in adding §20(a)]...was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.” (Emphasis added.) The court applied this test the following year, reversing a judgment of §20(a) liability for lack of evidence that the defendant had “knowledge of the fraudulent representations or in any meaningful sense culpably participated in them.” Gordon v. Burr, 506 F2d 1080, 1086 (2d Cir. 1974).

When the Second Circuit next considered a §20(a) claim, in Marbury Management v. Kohn, 629 F2d 705 (2d Cir. 1980), it reversed a judgment for a brokerage house on a claim of aiding and abetting securities fraud by an unlicensed salesman with the firm. The court held that the district court should have considered other theories of liability, such as §20(a). Under §20(a), the court noted, “where...the erring salesman completes the transactions through the employing brokerage house and the brokerage house receives a commission on the transaction, the burden of proving good faith is shifted to the brokerage house.” The court did not explicitly discuss “culpable participation,” which some district courts have interpreted as a rejection of that element.

To reconcile the apparent split, the court held in SEC v. First Jersey Securities, Inc., 101 F3d 1450 (2d Cir. 1996), that “to establish a prima facie case under §20(a), "a plaintiff must show" a primary violation, control and "that the controlling person was in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[,]” quoting Lanza and Gordon, and citing to Marbury. Once a plaintiff makes out wwww prima facie case, the court said, “the burden shifts to the defendant to show that he acted in good faith, and that he did not directly or indirectly induce the act or acts constituting the violation.”

Since First Jersey, each time the Second Circuit has considered §20(a), it has reiterated this three-pronged standard. In doing so, the Second Circuit is squarely in the minority among circuit courts, along with the U.S. Court of Appeals for the Third and Fourth circuits. The remaining circuits to address the issue—the Fifth, Seventh, Eighth, Ninth, Tenth and Eleventh—require a showing only of a primary violation and control.

The district courts in the Second Circuit followed First Jersey, at least for a time. In In re Independent Energy Holdings PLC Securities Litigation, 154 FSupp2d 741, 771 (SDNY 2001), for example, Judge Shira Scheindlin held that the
$20(a) standard is "clear," and that it included pleading culpable participation—both "fraudulent conduct" and "the requisite state of mind"—with particularity.

The Minority View

Two years after Independent Energy, Judge Scheindlin— remarking that wisdom often "comes late"—changed course. In In re Initial Public Offering Securities Litigation, 241 F.Supp.2d 281, 392-97 (S.D.N.Y. 2003) (IPO Secs. Litig.), she held that "culpable participation" was not an essential element for pleading a §20(a) claim (and indeed, that the Second Circuit "has yet to definitively answer" whether scienter is part of §20(a) at all). This conclusion rested upon several premises, the most significant of which require a closer examination.

First, the IPO Secs. Litig. court held that the Court of Appeals itself had "essentially rendered the 'culpable participation' requirement meaningless" whenever it sought to apply it. For example, in First Jersey, after laying out the §20(a) standard, the Court of Appeals went on to state that the district court properly found a primary violation and that the defendant was a controlling person, and "[h]ence," the burden shifted to the defendant to establish his defense. From this passage, the IPO Secs. Litig. court concluded that culpable participation is not required to establish a §20(a) claim. But taken in context, the First Jersey passage is in a section of the opinion titled "Personal Liability," in which the Court of Appeals was considering the defendant's liability either as a primary violator or as a controlling person. Before even reaching §20(a), the Court of Appeals held that the district court properly concluded the defendant "knowingly...orchestrated every facet of" the fraud.

Second, the IPO Secs. Litig. court suggested that First Jersey merely described burdens of proof in the case, but not what a plaintiff must plead. Under this theory, a plaintiff must plead only a primary violation and control, while "culpable participation" simply describes the defendant's affirmative defense. While it is true that First Jersey was not a pleading case, the Court of Appeals nonetheless stated that culpable participation was part of the plaintiff's "prima facie" showing. Because a plaintiff who cannot make any showing of culpable participation fails in its prima facie claim as a matter of law, it follows that a plaintiff must allege culpable participation to survive a motion to dismiss for "failure of the pleading to state a claim upon which relief can be granted." See Mishkin v. Ageloff, No. 97 Civ. 2690, 1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998) (Preska, J.) (holding that First Jersey substantially changed §20(a) analysis because it used "prima facie" in describing the test).

Third, the IPO Secs. Litig. court analogized §20(a) to §11 of the 1933 Securities Act, in which a plaintiff need not plead scienter, although certain defendants may rebut liability by pleading and establishing an affirmative defense of due diligence. The court reasoned that, similar to the mechanics of §11, §20(a) does not require plaintiffs to plead scienter or any other "culpability," but merely shifts the burden to defendants to establish a prima facie affirmative defense—good faith and the absence of conduct inducing the violation. Section 20(a) does not, however—as §11 does—state that a particular "burden of proof" is borne by the defendant alone. Instead, §20(a) merely describes the conditions for a defendant's liability: a primary violation, control and the lack of good faith and conduct inducing the violation. As shown with §11 (and many other statutes), when Congress wants to shift a burden of proof or pleading to a defendant, it knows how to do so.

Fourth, the IPO Secs. Litig. court reviewed the legislative history and cited two 1934 congressional reports for support, but each merely reiterated the language of §20(a). Other courts have conducted more extensive analysis of the legislative history of the securities laws and found that Congress in no way intended §20(a) to extend liability to controlling persons without regard to their state of mind. See Rochez Bros., Inc. v. Rhodes, 527 F.2d 880, 889-90 (3d Cir. 1975).

Adding to the controversy, even among the majority of district courts in the Second Circuit that holds that "culpable participation" is an element of a §20(a) claim, there is no uniformity on what this element actually requires.

Judge Scheindlin concluded that a plaintiff need not show "culpable participation" and "need only prove scienter if a defendant presents the affirmative defense that it acted in good faith." Two district judges in the circuit have followed suit: Judge Lewis Kaplan called the Second Circuit's culpable participation element "a loosely stated element of a §20(a) claim," In re Parmalat Secs. Litig., 375 F.Supp.2d 278, 309 (S.D.N.Y. 2005), and Judge Denise L. Cote held that "the concept of culpable participation describes that degree of control which is sufficient to render a person liable under Section 20(a)," In re WorldCom, Inc. Secs. Litig., 241 F.Supp.2d 392, 415 (S.D.N.Y. 2003) (reversing course from her own earlier decisions). These conclusions appear open to question, in light of stare decisis—i.e., First Jersey and several subsequent Second Circuit cases (including pleading cases)—accepted §20(a) claims before it and held in unambiguous terms that a primary facie claim involves three separate elements—a primary violation, control and culpable participation.

The vast majority of post-First Jersey district court decisions within the Second Circuit reject the view that culpable participation is not required. See, e.g., In re Global Crossing, Ltd. Secs. Litig., 322 F.Supp.2d 319, 349 (S.D.N.Y. 2004) (accepting, as settled, the culpable participation requirement). In Lapin, Judge Karas surveyed the state of Second Circuit law and agreed with this approach, holding that "culpable participation" is a pleading requirement.

'Culpable Participation'

Adding controversy upon controversy, even among the majority of district courts within the Second Circuit which hold that "culpable participation" is an element of a §20(a) claim, there is no uniformity regarding what this element actually requires. On one end of the spectrum, most courts have equated it with the scienter requirement of §10(b) claims, requiring a showing of recklessness, conscious misbehavior or either of the two. See, e.g., In re Vivendi Universal, S.A., 381 F.Supp.2d 158, 189 (S.D.N.Y. 2003). These district courts generally—but not universally—hold plaintiffs to the heightened pleading requirements of the PSLRA. This was Judge Karas' conclusion in Lapin, determining that "this conclusion is most consistent with the decisions of the Second Circuit and the PSLRA." On the other end of the spectrum are a few courts holding that a plaintiff need only allege a defendant "knew or should have known" about the fraud. See, e.g., In re Blech Secs. Litig., No. 94 Civ. 7696, 2002 WL 31356498 at *21 (S.D.N.Y. Oct. 17, 2002).

Conclusion

As one court has recognized, "nothing is clear in this area of §20(A)." In re Flag Telecom Holdings, Ltd. Secs. Litig., 308 F.Supp.2d 249, 273 (S.D.N.Y. 2004). To the extent generalizations may be made, it can be said that most district judges in the Second Circuit recognize, as Judge Karas noted in Lapin, that "the Second Circuit has spoken and...until it holds otherwise, some level of culpable participation at least approximating recklessness in the §10(b) context must be alleged to state a §20(a) claim," and that plaintiffs must do so with particularity. But practitioners would do well to review their particular judge's most recent opinion on the issue before addressing it. Better still if the Second Circuit clarifies this issue once and for all at its next opportunity.

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