NOTE

CONTROLLING THE CONTROLLERS: SECTION 20(A) CONTROL PERSON LIABILITY AND PROMOTING GATEKEEPER BEHAVIOR AMONG OFFICERS AND DIRECTORS

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Section 20(a) of the Securities Exchange Act of 1934 allows controlling persons to be held vicariously liable for breaches of the securities laws by parties whom they control. A circuit split has emerged between the Second and the Ninth Circuits concerning whether a plaintiff must show that a control person defendant was a culpable participant in the violative act. This Note argues in favor of the Ninth Circuit standard which holds that plaintiffs should not be required to plead that control person defendants were culpable participants. In doing so, this Note argues that broader exposure for control persons would encourage increased monitoring and gatekeeper behavior among officers and directors.

Introduction 876
Part I 877
A. Background of Section 20(a) and the Legal Problem 877
i. Second Circuit 881
ii. Ninth Circuit 884
Part II 887

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A. Critical Examination of Legislative History and Text 887
B. Examination of the Case Law 891
Part III: Section 20(a) and Controlling Persons as Gatekeepers 898
A. Gatekeeping for Officers 899
B. Gatekeeping for Directors 900
C. The 9th Circuit Standard will Promote Gatekeeping and Deter Wrongful Behavior 904
i. Discarding Culpable Participation Will Enhance Section 20(a) 905
ii. Good Faith Defense 906
iii. Potential Trade Offs and Complications; Overcompliance and Monitoring Costs 907
D. Solutions 908
i. Clear Standards of Responsibility and Tailoring Liability 909
ii. Cheap and Effective Monitoring 910
Conclusion 911

INTRODUCTION

Who is to blame when a company violates securities laws? Of course, individuals directly responsible for any fraud or misrepresentation should be held culpable for such transgressions. However, should those with control over the parties engaging in the violative acts be liable as well? The answer to this question, as provided by Section 20(a) of the Securities Exchange Act of 1934, is yes. Section 20(a) allows controlling persons to be held liable for breaches of the 1934 Act if the defendant "directly or indirectly, controls any person liable" under the Act.[1] However, in the application of Section 20(a) a question soon arose: how should control be interpreted, and in which situations should liability be imposed on those deemed as controlling persons? In other words, who should be considered a controlling person in the context of Section 20(a) liability, and how involved in the alleged violative act must

[1] 15 U.S.C. § 78t.

they have been to be held liable for the wrongdoings of parties they are deemed to control? This question has been examined by a number of courts, particularly those in the Second and Ninth Circuits.[2]

This Note argues for the widespread adoption of the Ninth Circuit's approach to Section 20(a) liability on multiple grounds. First, the Ninth Circuit's approach adheres closer to the text of Section 20(a) and to the intent of Congress in drafting Section 20(a). Second, it allocates the burden of evidence to the party with the greatest ease in accessing such evidence. Lastly, it induces corporate management and directors to serve in a gatekeeping capacity and to better monitor the behavior of agents and third-party affiliates. In Part 1, I discuss the background of Section 20(a) and framing the legal problem it presents. Further, I discuss the current circuit split, as well as the case law that divergent circuits cite. In Part II, I discuss the text and legislative history of Section 20(a) and examine the arguments presented by the circuit and district courts. Next, I argue in favor of the widespread adoption of the Ninth Circuit's plaintiff-friendly interpretation of Section 20(a) liability. In particular, I advocate for its role in advancing gatekeeping functions among officers and directors. In Part III, I discuss possible tradeoffs with respect to an expansion of liability under Section 20(a), and I propose establishing clear standards of responsibility, tailoring liability, and promoting cheap and effective monitoring as possible solutions.

PART I

A. Background of Section 20(a) and the Legal Problem

The Securities Exchange Act of 1934 was part of a wave of securities regulation enacted following the collapse of the

[2] *See*, *e.g.*, SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996); Hollinger v. Titan Cap. Corp., 914 F.2d 1564 (9th Cir. 1990).

stock market in 1929.[3] The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted in part to restore the investing public's confidence in the securities market in the wake of the crash, as well as in hopes of stimulating economic activity and regulating the securities market going forward.[4] While the Securities Act of 1933 was designed to regulate the issuance of new securities—the primary market, the Securities Exchange Act of 1934 was intended to regulate the market for already issued securities—the secondary market.[5] Section 20(a) of the 1934 Act allows shareholders to sue parties deemed to be controlling persons for vicarious violations of the 1934 Act. Section 20(a) states,

> [e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 21(d)), 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.[6]

The statutory language of Section 20(a) presents important ambiguities, however, which can significantly affect how Section 20(a) works in practice.

[3] *See* Erin L. Massey, *Control Person Liability under Section 20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 111 (2006).

[4] *See* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 330 (1988).

[5] *Id.* ("The general purpose of the Securities Act is to regulate the initial distribution of securities by issuers to public investors. . . . The Exchange Act provides for the regulation of the securities exchange markets and the operations of the corporations listed on the various national securities exchanges . . . .").

[6] 15 U.S.C. § 78t.

One question courts must answer is how the word "control" should be interpreted.[7] What kind of relationship must the defendant have with the alleged perpetrator of the violative act to be considered a controlling person, and to what extent must the defendant have exercised that control? Congress itself has provided no answer to this question by failing to define the term.[8] The SEC has provided some guidance on this issue by defining control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[9] However, even with this guidance from the SEC, the exact meaning of control when applied to violations of the 1934 Act has been ambiguous. Therefore, it has been the role of the courts to decide under which circumstances a party can be vicariously liable as a controlling person under Section 20(a). This question is vitally important to the application of Section 20(a) liability. In addition to the different definitions imposed by the circuit courts, there are other questions that feature more heavily in the circuit split.

A more significant and contentious question left open by Congress is whether it intended for there to be any scienter or culpable participation requirement as part of Section 20(a) liability. Does a controlling person have to be an active participant in the alleged violation to face potential liability under Section 20(a)? Is recklessness, or even mere negligence, sufficient for Section 20(a) liability? Like the issue of what constitutes control, these questions have been left to the courts.

Among the circuit courts, there is widespread agreement on fundamental aspects of Section 20(a) liability. The first

[7] *See* Youngers v. Virtus Investment Partners Inc., 195 F. Supp. 3d 499, 524 (S.D.N.Y. 2016).

[8] Massey, *supra* note 3, at 112; *see also* Brian A. Melhus, *Control Person Liability: A Repudiation of Culpable Participation*, 37 IOWA J. CORP. L. 929, 939 (2012) ("Congress recognized that the complexity of the securities market would make 'control' difficult to define.") (citing H.R. REP. No. 73-1383, at 26 (1934)).

[9] 17 C.F.R. § 230.405.

point of agreement is that there must be a breach of federal securities law before control person liability can be considered.[10] Courts have rejected Section 20(a) claims that lack a sufficient allegation of a predicate breach of relevant federal securities laws.[11] Second, the individual or entity being sued under Section 20(a) must be a controlling person, having some degree of control or authority over the violator.[12] Finally, multiple circuits agree that the controlling person has the opportunity to establish the affirmative defense of good faith based on the statutory language of Section 20(a).[13]

However, despite these basic agreements, there is a circuit split regarding whether a plaintiff must make an additional showing, after a successful control person allegation , that the defendant was a culpable participant in the alleged violation of the federal securities laws.[14] In circuits which have adopted

[10] *See* Golla v. Neovasc, Inc., No. 22-361-CV, 2023 WL 2469770, at *3 (2d Cir. Mar. 13, 2023) (quoting Rombach v. Chang, 355 F.3d 164, 177-78 (2d Cir. 2004)) ("a Section 20(a) violation must be 'predicated on a primary violation of securities law.'"); *see also* Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000) ("plaintiff must prove: (1) a primary violation of federal securities laws . . . .").

[11] *See Golla*, WL2469770, at*3 ("The District Court also properly dismissed Golla's Section 20(a) claim because it requires a primary violation of the securities laws, which Golla failed to adequately allege."); *see also* Weston Family P'ship LLLP v. Twitter, Inc., 29 F.4th 611, 623 (9th Cir. 2022) ("Plaintiffs did not adequately plead a primary violation of Section 10(b) or Rule 10b-5 by any defendant. Thus, control person liability under Section 20(a) cannot survive.").

[12] *See* Howard 228 F.3d at 1065 (stating that the defendant must have "exercised actual power or control over the primary violator[.]"); *see also* ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 108 (2d Cir. 2007) ("a plaintiff must show (1) a primary violation by the controlled person, (2) control of the primary violator by the defendant . . . .").

[13] 15 U.S.C. § 78t ("[U]nless 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."); *see also* SEC v. Lek Sec. Corp., 2019 U.S. Dist. LEXIS 192042, at *4 (referencing 15 U.S.C. § 78t in discussing the good faith defense).

[14] *See* Pravin Rao & Gabriel Tong, *Controlling Person Liability: Circuit Split Increasingly Relevant*, N.Y.L.J. 109 (Jun. 26, 2023), https://www.law.com/newyorklawjournal/2023/06/26/controlling-person-liability-circuit-split-increasingly-relevant/ [https://perma.cc/HJ9G-KKCE].

the culpable participation element of Section 20(a) liability, a liability determination against a controlling person will hinge on whether the plaintiff can make a sufficient showing that the controlling person was a culpable participant in the alleged wrongdoing. In this Note, I focus primarily on the Second and the Ninth Circuits, as these two circuits together see the most securities litigation and represent the two approaches that define this circuit split.[15] The choice of a plaintiff to sue in the Second or Ninth Circuit is a decision that "may produce drastically different results" with respect to the outcome of the litigation.[16]

i. Second Circuit

The Second Circuit falls at one end of the spectrum and is considered a more defendant-friendly jurisdiction.[17] In the Second Circuit, in order to establish a prima facie case for Section 20(a) liability, a plaintiff must make a showing that there was "(1) a primary violation by the controlled person, (2) control of the primary violator by the defendant, and (3) that the defendant was, in some meaningful sense, a culpable participant in the controlled person's fraud."[18] The first prong of the test is rather straightforward: if no violation of federal securities laws took place, the claim would be dismissed because there can be no cause of action under Section 20(a).[19] The remaining two prongs of the test deserve significantly more attention. It is also worth noting that a substantial

[15] *See* Janeen McIntosh & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2021 Full-Year Review*, NERA ECONOMICS CONSULTING (Jan. 25, 2022), https://www.nera.com/content/dam/nera/publications/2022/PUB_2021_Full-Year_Trends_012022.pdf [https://perma.cc/U73V-DQKE].

[16] Rao & Tong, *supra* note 14.

[17] *See id.*

[18] ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 108 (2d Cir. 2007) (citing S.E.C. v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996)).

[19] *See, e.g.*, Golla v. Neovasc, Inc., No. 22-361-CV, 2023 WL 2469770, at *3 (2d Cir. Mar. 13, 2023).

portion of the relevant case law in this area has developed in district courts, especially in the Southern District of New York, rather than in the Second Circuit itself.

Controlling Person: Once it is established that an applicable violation of the federal securities laws is properly alleged, then it must be shown that the violator was controlled by the defendant, thus making the defendant a controlling person. Courts in the Second Circuit have held that "[a]ctual control is essential to control person liability" and that "exercise of influence, without power to direct or cause the direction of management and policies through ownership of voting securities, by contract, or in any other direct way, is not sufficient to establish control for purposes of Section 20(a)."[20] In a recent Southern District of New York case, the court held that the plaintiffs adequately pled control person status when alleging that the Section 20(a) defendant was the CFO of the company during the class period and signed several of the relevant SEC filings.[21] While the Court noted that "[b]oilerplate allegations that a party controlled another based on officer or director status are insufficient," they concluded that "officers usually are presumed to possess the ability to control the actions of their employees[,] and directors and officers who sign registration statements or other SEC filings are presumed to control those who draft those documents."[22] Additionally, "[s]ubstantial influence is not the same as actual control, and "[a]ctual control is essential to control person liability."[23] The Second Circuit's interpretation of control adheres largely to the definition provided by the SEC, requiring the "power to direct" the activities of the

[20] *In re* Livent, Inc. Sec. Litig., 78 F. Supp. 2d 194, 221 (S.D.N.Y. 1999); *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 433, 487 (S.D.N.Y. 2005).

[21] Ap-Fonden v. GE, No. 17-CV-8457 (JMF), 2021 U.S. Dist. LEXIS 20319, at *49 (S.D.N.Y. Jan. 29, 2021).

[22] *Id.* (quoting Youngers v. Virtus Investment Partners Inc., 195 F. Supp. 3d 499, 524 (S.D.N.Y. 2016)); *id.* at *49-50 (quoting *In re* Bioscrip, Inc. Sec. Litig., 95 F.Supp.3d 711 (S.D.N.Y. 2015)).

[23] *In re* BioScrip, Inc. Sec. Litig., 95 F. Supp. 3d 711, 740 (S.D.N.Y. 2015) (quoting *In re* Blech Sec. Litig., 961 F.Supp. 569, 586 (S.D.N.Y. 1997)).

controlled person.[24] However, perhaps the Second Circuit's interpretation goes somewhat beyond the SEC's definition as it clarifies that "actual control" is required for control person liability, and substantial influence to direct is not sufficient.

Culpable Participation: The most important factor distinguishing the Second Circuit's application of Section 20(a) from that of the Ninth Circuit is the culpable participation requirement. In the Second Circuit, a plaintiff must show "that the controlling person was "in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[.]"[25] During the late 1990s and early 2000s there were questions of whether the Second Circuit was actually starting to do away with, or at least weaken, their culpable participation requirement.[26] However, the Second Circuit has reaffirmed the culpable participation requirement in numerous cases since.[27] Within the Second Circuit there is a split among the district courts regarding "whether culpable participation must be pleaded with the same particularity as scienter."[28] In the case of *In re Alstrom*, the Southern District of New York clarified that culpable participation "clearly requires 'something more than

[24] *See* 17 C.F.R. § 230.405.

[25] S.E.C. v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996) (internal quotation marks omitted) (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)).

[26] *See* Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 3 (1997) (referring to the "recent erosion of the 'culpable participation' doctrine in the Second, Fourth, and Ninth Circuits."); *see also* Erin L. Massey, *Control Person Liability under* Section *20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 117 (2006) ("[C]ircuits applying the culpable participation test are beginning to waiver in their adherence to such a strict pleading standard.") (citing *In re* Reliance Corp. Sec. Litig., 135 F. Supp. 2d 480, 518 (D. Del. 2001)).

[27] *See In re* Bernard L. Madoff Inv. Sec. LLC, 818 F. App'x 48, 55 (2d Cir. 2020) (stating that a defendant must have been "in some meaningful sense, a culpable participant in the controlled person's fraud") (quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 108 (2d Cir. 2007)).

[28] Ap-Fonden v. GE, No. 17-CV-8457 (JMF), 2021 U.S. Dist. LEXIS 20319, at *51 (S.D.N.Y. Jan. 29, 2021).

negligence.'"[29] There, the court held that recklessness should be the minimum standard for alleging culpable participation. Courts in the Second Circuit have also held that alleging culpable participation entails a heightened pleading requirement, and that the plaintiff "must plead with particularity facts giving rise to a strong inference that the controlling person knew or should have known that the primary violator, over whom that person had control, was engaging in fraudulent conduct."[30]

Good Faith: In the Second Circuit, after a prima facie Section 20(a) case is made by the plaintiff, "the burden shifts to the defendant to show that he acted in good faith" and that said defendant did not induce the violative acts either directly or indirectly.[31] In order to meet the burden of establishing the good faith defense, the defendant "must prove that he exercised due care in his supervision of the violator's activities in that he 'maintained and enforced a reasonable and proper system of supervision and internal controls.'"[32]

ii. Ninth Circuit

If out of the two principal jurisdictions for securities litigation the Second Circuit is the more defendant-friendly, then the Ninth Circuit serves as its foil, being the more plaintiff-friendly jurisdiction. In the Ninth Circuit, a defendant can be held liable under Section 20(a) "if (1) there is a violation of the [Exchange] Act and (2) the defendant directly or indirectly controls any person liable for the

[29] In re Alstom SA, 406 F. Supp. 2d 433, 490 (S.D.N.Y. 2005) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 209 n.28 (1976)).

[30] In re Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 661 (S.D.N.Y. 2007) (quoting *In re* Parmalat Secs. Litig., 383 F.Supp.2d 616, 627 & n.53 (S.D.N.Y. 2005)).

[31] SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1473 (2d Cir. 1996) (citing Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980) and 15 U.S.C. § 78t).

[32] *Id.* (quoting Marbury Management, Inc. v. Kohn, 629 F.2d at 716)).

violation."[33] The two prongs of the Ninth Circuit test are largely similar to their counterparts in the Second Circuit test. The main difference lies in the conspicuous absence of the culpable participation requirement, which was discarded in the Ninth Circuit.

In the Ninth Circuit defendants need to have "exercised actual power or control over the primary violator" in order to be considered a controlling person."[34] The fate of a Section 20(a) suit in the Ninth Circuit thus depends on how the court defines "actual power" and "control." It has been noted in the Ninth Circuit that "[w]hether [the defendant] is a controlling person is an intensely factual question, involving scrutiny of the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions."[35] While a defendant's status as an officer or director does not by itself "create any presumption of control" it nevertheless serves as "a sort of red light."[36] Notably, in making a prima facie case a plaintiff does not need to show "the exercise of actual power[.]"[37] Courts in the Ninth Circuit have also placed emphasis on whether defendants were involved in the day-to-day management of the company, particularly in cases in which there were relevant financial statements.[38] In these cases, defendants' involvement with day-to-day operations and with the financial statements may be "sufficient to presume control over the 'transactions giving rise to the alleged securities violation.'"[39]

[33] SEC v. Todd, 642 F.3d 1207, 1223 (9th Cir. 2011) (quoting Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000)).

[34] Webb v. SolarCity Corp., 884 F.3d 844, 858 (9th Cir. 2018) (quoting Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000)).

[35] Howard v. Everex Sys., 228 F.3d 1057, 1065 (9th Cir. 2000) (quoting Kaplan v. Rose, 49 F.3d 1363, 1382 (9th Cir. 1994)).

[36] Hessefort v. Super Micro Comput., Inc., No. 18-CV-00838, 2021 U.S. Dist. LEXIS 63629, at *47 (N.D. Cal. Mar. 29, 2021) (quoting Paracor Fin., Inc. v. GE Cap. Corp., 96 F.3d 1151, 1163 (9th Cir. 1996)).

[37] *Howard*, 228 F.3d at 1065.

[38] *See id.* at 1065–66.

[39] *Id.* at 1065 (quoting Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1441 (9th Cir. 1987)).

Rejection of the Culpable Participation Requirement: Prior to the Ninth Circuit's 1990 decision in *Hollinger v. Titan Capital Corp.* the court adopted a culpable participation standard.[40] However, in *Hollinger* the court dispensed of culpable participation in Section 20(a) suits.[41] While the *Hollinger* court noted that they reached their decision rejecting the necessity of pleading culpable participation "in the context of the broker-dealer/registered representative relationship exclusively," subsequent case law has firmly established that the culpable participation standard has been abandoned in all Section 20(a) claims.[42] Thus, in making a Section 20(a) claim, a plaintiff "does not have the burden of establishing that [controlling] person's scienter distinct from the controlled corporation's scienter."[43] Courts in the Ninth Circuit have tied culpable participation with the good faith defense. In rejecting the culpable participation standard, the Ninth Circuit has thus shifted the burden of proving scienter from the plaintiff to the defendant in the form of the good faith defense.[44]

Good Faith: Like a defendant in the Second Circuit, a Ninth Circuit defendant has the opportunity to avail themselves of an affirmative defense of good faith.[45] Precedent

[40] Erin L. Massey, *Control Person Liability under Section 20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 120–121 (2006).

[41] Hollinger v. Titan Cap. Corp., 914 F.2d 1564, 1575 (9th Cir. 1990).

[42] *Id.* at 1575 n. 24 (stating that the court rejected culpable participation in the context of the broker-dealer relationship); *see also* Howard v. Everex Sys., 228 F.3d 1057, 1065 (9th Cir. 2000) (noting that "[p]laintiff need not show that the defendant was a culpable participant" in a case not involving a broker-dealer)).

[43] *Howard*, 228 F.3d at 1065 (quoting Arthur Children's Trust v. Keim, 994 F.2d 1390, 1398 (9th Cir. 1993)).

[44] *Id.* at 1065 (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 ("Hollinger, although not entirely abandoning the participation element, shifted the burden to the defendant to show that 'she acted in good faith and did not directly or indirectly induce the violations.'")).

[45] *See* Hollinger, 914 F.2d at 1575 ("T]oday we return to what had once been the law of our circuit, namely that § 20(a) requires the defendant to prove his good faith.").

in the Ninth Circuit has established that "in an action based on § 20(a), the defendant who is a controlling person, and not the plaintiff, bears the burden of proof as to defendant's good faith."[46] The most significant difference here, when compared to the Second Circuit, is that without a culpable participation requirement, the burden of proof falls squarely on the defendant without the plaintiff first needing to prove that the defendant was a culpable participant in the violative act. Courts in the Ninth Circuit have also held that "[the good-faith] defense is unavailable even when the defendants who induced the fraud believed in good faith that they were not perpetrating a fraud[]," thereby signaling to potential controlling persons that they have an obligation to ensure that they are not inadvertently participating in fraudulent conduct.[47]

PART II

In order to understand Section 20(a) and the standards imposed upon plaintiffs and defendants in the different jurisdictions, it is important to understand the legislative history surrounding the adoption of Section 20(a). Likewise, it is also important to understand the arguments made by courts in addressing the most important questions surrounding Section 20(a) liability. In this section, I first discuss the legislative history and the purpose of Section 20(a). Then, I discuss the relevant case law in greater detail and analyze the arguments put forth by the courts. Finally, I discuss another aspect of Section 20(a) liability: whether the standards circuits have set for making a good faith defense impose any sort of duty on defendants to monitor the behavior of the parties that they control.

A. Critical Examination of Legislative History and Text

[46] *Id.*

[47] S.E.C. v. Todd, 642 F.3d 1207, 1224 (9th Cir. 2011) (quoting Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1434 (9th Cir. 1995)).

The legislative history and the intent of the drafters of Section 20(a) offer important insight as to how its provisions should be interpreted by courts. Thomas G. Corcoran, one of the principal architects of the 1934 Act, stated that the purpose of Section 20(a) "is to prevent evasion of the provisions of the section [claimed to have been violated] by organizing dummies who will undertake the actual things forbidden by the section."[48] Thus, one of the primary motivations in drafting Section 20(a) was to prevent corporate officers and directors from using employees and other people under their control to undertake prohibited acts in violation of the securities laws, while they themselves remain free of liability. This overarching goal of preventing controlling persons from using "dummies" to carry out violative acts while avoiding potential liability themselves explains judicial interpretations of control person status and the question of culpable participation that limits the possibility of controlling persons successfully evading liability when engaged in such a scheme. While the text of the statute itself may not provide direct instructions as to how to resolve the questions raised by Section 20(a), it does offer hints.

One particular example concerns the good faith language in the statute, which provides a defense to controlling persons provided they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[49] This is noteworthy because it is a broad defense, suitable to the broad liability imposed by Section 20(a).[50] This broad defense also fits with the notion that courts

[48] Lowenfels & Bromberg, *supra* note 26, at 7 (quoting *Stock Exchange Practices: Hearings on S.Res. 84 S. Res. 56, and S. Res. 97 Before the S. Comm. on Banking and Currency*, 73d Cong. 657-1 (1934) (statement of Thomas G. Corcoran, Office of Counsel, Reconstruction Finance Corporation)).

[49] 15 U.S.C. § 78t.

[50] *See* Lowenfels & Bromberg, *supra* note 26, at 6. ("it is important to note that the more broadly worded liability parameters of section 20(a) ('liable under any provision of this chapter or of any rule or regulation thereunder') have engendered a more broadly worded defense ('acted in good faith and did not directly or in- directly induce the act or acts constituting the violation or cause of action[.]')) (quoting 15 U.S.C. § 78t).

should interpret Section 20(a) in a plaintiff-friendly manner. If a court is concerned with the possibility that dropping the culpable participation pleading standard would ensnare defendant controlling persons who should not be held liable, then the robust good faith defense offered by the statute serves as an adequate protection for the defendants in such instances.[51] It follows that the only function the culpable participation requirement would serve is to allow defendants who did indeed use controlled persons as "dummies" to engage in wrongful behavior, escape liability, and defeat potentially valuable litigation through a motion to dismiss.

Some have argued that the legislative history does not support the idea that Congress intended to implement a strict liability standard with Section 20(a).[52] While this is likely true, it does not negate the expansive liability intended by Congress, nor does it necessitate the implementation of a culpable participation requirement. As discussed previously, the existence of an affirmative defense of good faith provides defendants with an adequate defense and ensures that Section 20(a) does not, in fact, have a strict liability standard even without a culpable participation requirement. The interpretation that Section 20(a) was intended to have expansive reach is further bolstered by the wide language concerning what it means to be a control person. In the language of Section 20(a) "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter" could be held liable as a control person.[53] The words "directly or indirectly" lend support to the notion that

[51] *See* Brian A. Melhus, *Control Person Liability: A Repudiation of Culpable Participation,* 37 J. CORP. L. 929, 947 (2012) ("[S]ection 20(a)'s statutory good faith defense ensures that control person liability will not become strict liability and thus provides adequate protection for the defendant's rights.").

[52] Lowenfels & Bromberg, *supra* note 26, at 8. ("Legislative history clearly supports congressional intent in enacting section 15 and section 20(a) to reject a standard of conduct which imposes strict liability, regardless of personal fault, upon controlling persons in favor of a standard that has been described as fiduciary, and that impose liability only upon those controlling persons who breach a duty of due care.").

[53] 15 U.S.C. § 78t.

Congress intended Section 20(a) to have a more expansive liability regime, as it allows for defendants who only indirectly controlled a culpable party to be held liable. The SEC's proposed definition of "control" also points towards a wider net of potential liability.[54]

Courts have commented on the text and legislative history of Section 20(a) as well. In *Lanza v. Dexel & Co.* the Second Circuit indicated that the language used in the statute suggested congressional intent for culpability to be a necessary prerequisite of liability under Section 20(a).[55] The court said that "[t]his intent was manifested by the constant usage of words such as "cunning," "manipulative," "deceptive," "fraudulent," "illicit," "fraud," and lack of "good faith," and the absence of language indicating liability for negligent or non-negligent conduct."[56] The Ninth Circuit had a different interpretation of the legislative history. In *Hollinger*, the court noted that "Congress expanded upon the common law, and in doing so, created a defense (the good faith defense) that would be available only to those who, under common law principles of *respondeat superior*, would have faced no liability at all."[57] However, even within the Second Circuit, district courts have voiced concerns regarding reconciling the plain language of Section 20(a) with the culpable participation requirement imposed by the Second Circuit. One court opined:

> The statute plainly imposes liability on a controlling person for any primary violation, unless the controlling person acted in good faith and did not induce the action. As has been noted by one court, the "interpretation most consistent with the text is that the defendant bears the burden of establishing good

[54] In addition to reiterating the "direct or indirect" language, the SEC includes a range of possible methods of control such as "through the ownership of voting securities, by contract, or otherwise." *See* 17 C.F.R. § 230.405.

[55] Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

[56] *Id.* at 1299.

[57] Hollinger v. Titan Cap. Corp., 914 F.2d 1564, 1577 (9th Cir. 1990).

> faith and lack of inducement, not that the plaintiff must allege the opposite in its pleadings."[58]

The court went on to say, "whatever may be said among district courts about reconciling the plain language of section 20(a) and a requirement that scienter be pled, the Second Circuit has spoken and has imposed a "culpable participation" requirement to make out a prima facie case . . . . [U]ntil the Second Circuit holds otherwise, some level of culpable participation at least approximating recklessness in the section 10(b) context must be alleged to state a section 20(a) claim.[59]

While the Second Circuit has interpreted the statutory language as evidencing an intent to limit Section 20(a) liability to cases where the defendant was a culpable participant in the wrongdoing, the Ninth Circuit focused on the good faith defense in their reasoning that such a requirement was not intended by Congress. Meanwhile, the dissent within the Second Circuit among some of the district court judges shows that, while bound to the decisions of the appellate court, many judges within the Second Circuit have examined both arguments and lent their support to the idea that the statutory language indicates that culpable participation should not be required.

B. Examination of the Case Law

Second Circuit Arguments: A foundational case in the Second Circuit's Section 20(a) jurisprudence is *S.E.C. v. First Jersey Securities, Inc.*, [60] decided in 1996. There, the court confirmed earlier holdings stating that, in addition to showing a primary violation by the controlled person and control of the violator by the defendant, the plaintiff must show that the defendant was "in some meaningful sense [a] culpable

[58] Lapin v. Goldman Sachs Grp., Inc., 506 F. Supp. 2d 221, 248 (S.D.N.Y. 2006) (quoting *In re* Parmalat Sec. Litig., 375 F.Supp.2d 278, 308 (S.D.N.Y. 2005)).

[59] *Id.* at 248.

[60] S.E.C. v. First Jersey Securities, Inc., 101 F.3d 1450 (2d Cir. 1996).

participant[] in the fraud perpetrated by [the] controlled person[.]"[61] After the plaintiff successfully makes a showing of all three prongs, the burden shifts to the defendant to show that they acted in good faith. Here the defendant can show that they "did not directly or indirectly induce the act or acts constituting the violation" and that they "exercised due care in [their] supervision of the violator's activities in that [they] 'maintained and enforced a reasonable and proper system of supervision and internal control[s].'"[62] The court analyzed the efforts by the company to ensure compliance with rules implemented by the SEC and the National Association of Securities Dealers. However, the Court found the company's efforts lacking and agreed with the district court's conclusion that the "compliance efforts were more cosmetic than real."[63]

Given the ability of the defendant to protect themselves with the good faith defense, one would be justified in seeing it as redundant that the plaintiff also shares the burden of proof in showing culpable participation. Just as district courts within the Second Circuit have pointed out that the culpable participation requirement is not the most consistent with the statutory text, they have also criticized the fact that "although 'requiring the plaintiff to plead culpability, [while] at the same time requiring the defendant to prove good faith at trial, engenders an awkward allocation of pleading and proof whereby both parties bear burdens on the same issue[,] . . . [n]othing precludes such a burden-shifting scheme[.]'"[64] As the plaintiff needs to make a showing of culpable participation when pleading, the initial burden in the burden shifting regime starts with said plaintiff before shifting to defendant

[61] *See id.* at 1472 (2d Cir. 1996) (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)).

[62] *See id.* at 1473 (quoting 15 U.S.C. § 78t and Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980)).

[63] *Id.*

[64] *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 433, 489 (S.D.N.Y. 2005) (quoting *In re* Livent, Inc. Noteholders Sec. Litig., 151 F.Supp.2d 371, 416 (S.D.N.Y. 2001)).

in the form of the good faith defense.[65] This burden shifting arrangement creates a problem where the party with the easiest access to information—the defendant—is able to wait for the plaintiff to make an initial showing of culpable participation. Given that the defendant would have access to information which would only be available for the plaintiff during discovery, it makes sense for the defendant to have to bear the burden of proof in proving that they were not culpable in the alleged securities violation rather than the plaintiff bearing the burden of proving that they were culpable.

Ninth Circuit Arguments: The most important case influencing current doctrine in regard to Section 20(a) pleading standards in the Ninth Circuit is *Hollinger v. Titan Capital Corp*.[66] In *Hollinger*, the plaintiffs brought suit against a broker-dealer whose agent had committed violative acts.[67] Here the court discarded the culpable participation requirement. The defendant corporation argued that it could not be held liable as a controlling person when the plaintiff had not met their burden in establishing that the defendant was a culpable participant in the misdeeds, as was then required by Ninth Circuit case law.[68] Instead, the Court held that the statute does not place "such a burden on the plaintiff."[69] Here, the court based their holding in the language of Section 20(a) itself. They decided that the statute "premises liability solely on the control relationship[.]"[70] This is a much more natural reading of the text of the statute and respects the expansive liability intended by its drafters. Instead of a culpable participation requirement, the court notes that control person liability is "subject to the good faith

[65] *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d at 486 ("Once a plaintiff makes [] out a prima facie case of liability under Section 20(a), the burden shifts to the defendant to show that he or she acted in good faith and did not directly or indirectly induce the act or acts constituting the violation.").

[66] Hollinger v. Titan Cap. Corp., 914 F.2d 1564, 1566 (9th Cir. 1990).

[67] *See id.*

[68] *See id.* at 1574.

[69] *Id.* at 1575.

[70] *Id.*

defense[]" and that the "defendant bears the burden of proof to show his good faith."[71] This allocation of the burden of proof avoids the strange situation present in the Second Circuit, where the plaintiff has the burden to show culpable participation, despite both the defendant being in a better position to access evidence prior to discovery and the availability of the good faith defense. Because the defendant can attempt to show good faith in both interpretations, it is redundant to require the burden to start with the plaintiff as the Second Circuit does.

Duty to Monitor: Is there a duty to monitor under Section 20(A)?

Another important question to consider under Section 20(a) is to what extent, in any circuit, the statute imposes upon a controlling person a duty to monitor the actions of a controlled person. In discussing this question, it is best to look back at the text of the statute. Section 20(a) makes controlling persons liable to "the same extent as such controlled person to any person to whom such controlled person is liable[.]"[72] The statute also provides a defense of good faith which protects defendants who "acted in good faith and did not directly or indirectly induce the act[.]"[73] Taken alone, the former should allow controlling persons to be held liable for violations which occurred due to their failure to adequately monitor those whom they control. However, due to the presence of the good faith defense, a control person's duty to monitor is a more complicated question. If a controlling person induced the violative act, then the good faith defense would not protect them. Therefore, the issue remains whether one can act in "good faith" while still failing in their duty to monitor. If a failure to monitor can negate an inference of good faith, then a new question arises: how severe must a controlling person's lack of oversight be for them to be held liable?

[71] *Id.*
[72] 15 U.S.C. § 78t.
[73] *Id.*

In the Second Circuit, "recklessness is the minimum standard of culpability that plaintiffs must plead under Section 20(a)."[74] To have been reckless, conduct "must have been 'highly unreasonable,' representing 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'"[75] Additionally, an "egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness."[76] Recklessness in the Second Circuit typically is "established when plaintiffs (1) specifically allege defendants' awareness of facts or access to information contradicting their public statements and thus that they knew or should have known they were misrepresenting material facts related to the corporation; or (2) allege facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud."[77] Thus, within the Second Circuit, a controlling person who fails to review or check information that they had a duty to monitor, or who ignored signs of fraud from their controlled persons, could be liable under Section 20(a) for their reckless behavior.

In the Ninth Circuit a defendant "cannot satisfy its burden of proving good faith merely by saying that it has supervisory procedures in place, and therefore, it has fulfilled its duty to supervise."[78] Rather, they must have "maintained and enforced a reasonable and proper system of supervision and internal control."[79] As indicated in the Second Circuit, a defendant cannot claim good faith if they failed to adequately supervise and monitor their controlled persons. Case law in the Ninth Circuit also prompts controlling persons to

[74] *In re* Alstom SA, 406 F. Supp. 2d 433, 490 (S.D.N.Y. 2005) (citing *In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371 (S.D.N.Y. 2001)).

[75] *Id.* at 491 (quoting Rothman v. Gregor, 220 F.3d 81, 90 (2d Cir. 2000)).

[76] *Id.* (quoting Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000)).

[77] *Id.*

[78] Hollinger v. Titan Cap. Corp., 914 F.2d 1564, 1576 (9th Cir. 1990).

[79] *Id.* (quoting Zweig v. Hearst Corp., 521 F.2d 1129, 1134–35 (9th Cir. 1975)).

thoroughly monitor the behavior of those control. The 9th Circuit holds controlling persons liable if they approve fraudulent actions, even if they did not know that the actions they approved were fraudulent behavior.[80]

In addition, the text of the statute, Section 20(a), provides a defense for controlling persons who "acted in good faith and did not directly or indirectly induce the [violative] act[.]"[81] Given that the statute uses the word "or" rather than "and," the controlling person can still be held liable under Section 20(a) if they did not act in good faith, even when a controlling person did not directly or indirectly induce the culpable act committed by the controlled person. Both the Second and the Ninth Circuit recognize some degree of recklessness or failure to supervise as potentially rebutting an inference of good faith. However, while the Ninth Circuit requires a defendant to have "maintained and enforced a reasonable and proper system of supervision and internal control[],"[82] it is unclear if the same standard applies in the Second Circuit. In the Second Circuit, a plaintiff can "allege facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud,"[83] without reference to necessary systems of supervision and controls.

It is not immediately clear if the Second Circuit's standard would also encompass monitoring the behavior of controlled persons, in addition to verifying information. In the past, the Second Circuit departed on one occasion from its culpable participation requirement in a broker-dealer case involving

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[80] *See* Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1434 (9th Cir. 1995) ("The [good faith] defense is unavailable even when the defendants who induced the fraud believed in good faith that they were not perpetrating a fraud . . . . [A] controlling person who approves actions constituting fraud activity cannot invoke the good faith defense, even if he has no knowledge of the deceit.") (citing Myzel v. Fields, 386 F.2d 718, 738–39 (8th Cir. 1967)).

[81] 15 U.S.C. § 78t.

[82] *Id.* (quoting Zweig v. Hearst Corp., 521 F.2d 1129, 1134–35 (9th Cir. 1975)).

[83] *Id.* (citing Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000)).

supervision.[84] In the 1980 case of *Marbury Management Inc. v. Kohn*, the Second Circuit held "the burden of proving good faith is shifted to the brokerage house . . . and requires it to show at least that it has not been negligent in supervision . . . and that it has maintained and enforced a reasonable and proper system of supervision and internal control over sales personnel."[85] The court notes that while the defendants were able to deflect the allegation that they had aided and abetted in the violative act, that alone "does not establish that [the defendants have] borne the burden of proving "good faith" under the last clause of Section 20(a)."[86] Rather, the court's findings indicated that the Section 20(a) defendants "had [not] shown due care in its supervision and control of Kohn's activities."[87]

It is this reasoning, in line with that articulated by the Ninth Circuit, that the Second Circuit should continue to embrace. Even if a defendant did not induce the violative act, they should be held accountable when, as a controlling person, a violative action which could have and should have been prevented by reasonable supervision, oversight, and monitoring, occurs under their watch. While this holding was reached in the broker-dealer context, so was the Ninth Circuit's original repudiation of the culpable participation requirement in *Hollinger*. Just as subsequent case law in the Ninth Circuit expanded upon the *Hollinger* decision to eliminate culpable participation entirely, bringing Section (20) closer to its goals, courts should expand the interpretation of good faith in the broker-dealer context to encompass a wide range of control person scenarios.

[84] Michael A. Bednarz, *Let's Be Frank: The Future Direction of Controlling Person Liability Remains Uncertain*, 46 Suffolk U. L. REV. 551, 562 (2013).

[85] Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980) (internal citations omitted) (citing Zweig v. Hearst Corp., 521 F.2d 1129, 1134–35 (9th Cir. 1975)).

[86] *Id.*

[87] *Id.*

PART III: SECTION 20(A) AND CONTROLLING PERSONS AS GATEKEEPERS

Much ink has been spilled discussing the role of outside third-party affiliates of corporations, such as attorneys, accountants, and underwriters, as gatekeepers.[88] Less scholarship, however, has been written regarding the gatekeeping function of corporate officers and directors themselves. Due to their close involvement with the day-to-day business of the corporation, corporate officers have the potential to provide a more immediate gatekeeping function with greater knowledge of the business. Meanwhile, directors have the ability to oversee management.

Marc I. Steinberg and Forrest C. Roberts discuss officers and directors as gatekeepers in the Section 20(a) context.[89] Discussing the role of SEC enforcement actions in holding control persons accountable, the authors focus on the role of the SEC in using Section 20(a) as a tool to induce gatekeepers to fulfil their "statutory obligations."[90] The authors contend that "invocation of this provision [Section 20(a)] would provide a powerful incentive for executives and directors to more deeply acknowledge that their respective companies must comply with the law—or face the sobering reality of being named in an SEC enforcement action."[91] The power of Section 20(a) in inducing officers and directors to serve as gatekeepers, whether it is used by the SEC or by private plaintiffs, would only be enhanced by adopting a more plaintiff-friendly standard of pleading and liability. As most securities litigation takes place in the Second Circuit, the full potential of Section 20(a) cannot be realized unless a standard akin to that of the Ninth Circuit becomes more widespread.

[88] *See, e.g.*, JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

[89] *See generally* Marc I. Steinberg & Forrest C. Roberts, *Laxity at the Gates: The SEC's Neglect to Enforce Control Person Liability*, 11 VA. L. & BUS. REV. 201 (2017).

[90] *Id.* at 201.

[91] *Id.* at 247.

Potential liability provides a powerful incentive for corporate officers and directors to monitor their businesses, one of the most important responsibilities such positions entail.[92] Management and directors each have important roles to play in monitoring the company for compliance and in preventing any wrongdoings. Officers are best suited to monitoring the day-to-day activities of the company. As control persons, officers are in the position to prevent those whom they control from committing violative acts which could implicate the officers themselves in a Section 20(a) action. The directors on the other hand are well placed to monitor the activities of management. Such monitoring ensures that the directors both monitor the monitors–making sure that management adequately performs their role as gatekeepers in regard to the day-to-day functions of the company—and do not themselves engage in wrongful acts that would bring them afoul of federal securities laws.

A. Gatekeeping for Officers

Officers can serve an important gatekeeping function within an organization. As the day-to-day operators of the company at the ground level, officers have the best ability to prevent violations of federal securities laws. In preventing corporate wrongdoing, it is important to underscore that any violations are committed by individuals. As noted by Andrew Tuch, a "corporation is simply a fictional person, the relevant acts comprising securities fraud are performed by an individual or individuals."[93] Therefore,"[gatekeeper] liability would create incentives for the corporation and its managers

[92] *See* Eric J. Pan, *Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 FLA. ST. U. L. REV. 209, 210 (2011) ("[T]he duty to monitor serves as the best means the law has to ensure that directors are attentive and vigilant against the occurrence of harm to the corporation. To the extent we believe and expect a board to perform a substantial role in managing the corporation-as opposed to serving merely as review and approval bodies for the wants and wishes of officers-it is appropriate to hold boards to a high monitoring standard.").

[93] Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1608 (2010).

to take precautions in the exercise of their control over individual wrongdoers."[94] Monitoring is one important function that corporate officers can undertake. In discussing "gatekeeper regulatory mandates" more broadly, Rory Van Loo notes that "one strategy that firms have deployed is to limit their visibility into the third party's affairs, which later enables them to claim that they should not be expected to have known."[95] Van Loo goes on to say that mandates aimed at improving gatekeeping can make this strategy ineffective.[96] While Van Loo was not discussing Section 20(a) liability specifically, the same rationale can be used in this context. Higher risk of liability for controlling persons could make officers more inclined to implement structures to monitor the activities of those they control.

B. Gatekeeping for Directors

In addition to management, directors can also serve an important role in preventing violations of securities laws by acting as gatekeepers. While corporate officers, given their direct involvement in the day-to-day activities of the company, have the best ability to monitor employees and agents of the company, directors are able to monitor management itself. This is particularly true for outside directors, whose independent status places them among accountants and attorneys in their specialized ability to gatekeep by virtue of their position as outsiders.[97] Given their ultimate ability to control "all other corporate personnel," it is not unusual for

[94] *Id.*

[95] Rory Van Loo, *The Revival of Respondeat Superior and Evolution of Gatekeeper Liability*, 109 GEO. L.J. 141, 162 (2020).

[96] *Id.* (footnote omitted) ("At the very least, gatekeeper mandates are worth considering in the context of third-party liability because one strategy that firms have deployed is to limit their visibility into the third party's affairs, which later enables them to claim that they should not be expected to have known. Gatekeeper regulatory mandates make those self-blinding strategies ineffective.").

[97] Peter J. Henning, *The New Corporate Gatekeeper*, 62 WAYNE L. REV. 29, fn.1 (2016) (quoting Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 890 (1984)).

directors to find themselves as defendants in a Section 20(a) suit.[98] Of course, one's status as a director alone does not render one a controlling person, as a director-defendant must be shown to have been a controlling person under the same criteria as an officer.[99] One of the most important roles for the board is to "set up guard rails" for the corporation's management and to protect shareholders from "corporate malfeasance."[100] However, despite the presence of independent directors, boards in many cases fail to adequately serve their gatekeeping function.[101] For example, in a 2016 Wells Fargo scandal, the Federal Reserve stated that the Wells Fargo board's lead independent director "did not appear to lead the independent directors in pressing firm management for more information and action, even after [he was] aware of the seriousness of the problems[.]"[102] While directors have the ability to monitor management for wrongdoings—and for out purposes specifically, violations of federal securities laws—director oversight has been lacking in many critical instances director oversight.

The increased exposure to Section 20(a) liability under the Ninth Circuit standard could induce directors, as controlling persons, to better monitor management and the company. For example, amidst rising legal liability for directors in the 1980s, companies started to increasingly hire outside audit firms and form audit committees in order to avoid legal

[98] Sandra P. Wysocki, *Controlling Personal Liability of Directors under Section 20(a) of the Securities Exchange Act of 1934*, 31 SUFFOLK U. L. REV. 695, 695 (1998).

[99] *Id.* at 713; *In re* Philip Servs. Corp. Sec. Litig., 383 F. Supp. 2d 463, 485 (S.D.N.Y. 2004) (quoting *In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 309 (E.D.N.Y. 2002)).

[100] Yaron Nili, *Board Gatekeepers*, 72 EMORY L.J. 91, 94 (2022).

[101] *Id.* at 96.

[102] *Id.* at 97 (quoting Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Accountability as Lead Independent Director of Wells Fargo & Company Board of Directors (Feb. 2, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf).

exposure.[103] When directors know that they may face liability for the wrongdoings of management, they are likely to be more inclined to closely monitor management's behavior. Outside directors also have a unique ability to act as gatekeepers due to their unique relationship with management. Most other gatekeepers, such as lawyers and accountants, are hired and fired by management.[104] Therefore, "managers have become gatekeepers' real principals. As a result, the watchdogs have become the pets of those who feed them."[105] A possible solution to this problem, is to incentivize directors to act as gatekeepers themselves, and to monitor the behavior of management to ensure that the company is not violating securities laws. A legal regime which gives directors increased exposure to liability under Section 20(a) could be a viable solution.

However, while directors can serve as an important safeguard in situations where other gatekeepers have become creatures of management; there is a question within corporate governance of whether, and to what degree, independent directors have been co-opted by management themselves.[106] Monitoring management and defending the interests of shareholders, particularly when such interests are in conflict with the self-interested goals of management, are arguably among the most important functions of the independent director. A board which has been co-opted by management is can lead to less monitoring.[107] The extent to which a board has been co-opted can be ascertained through "the fraction of the board comprised of directors appointed after the CEO

[103] John W. Eichenseher & David Shield, *Corporate Director Liability and Monitoring Preferences*, 4 JOURNAL OF ACCOUNTING AND PUBLIC POLICY 1 13, 16 (1985).

[104] *See* Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089, 1092 (2008).

[105] *Id.*

[106] S. Burcu Avci et al., *The Elusive Monitoring Function of Independent Directors*, 21 U. PA. J. BUS. L. 235, 260 (2018).

[107] *See id.* at 260 (citing Jeffrey L. Coles, et al., *Co-Opted Boards*, 27 REV. FIN. STUD. 1751, 1753 (2014)).

assumed office, making them likelier to side with the CEO."[108] One study found that many independent directors have been co-opted by management based on their participation in insider trading schemes.[109] The authors postulate that "[i]f independent directors are effective at monitoring other executives, then we would expect they would not be heavy sellers of company stock during the class action period. If, however, independent directors are coopted by management, we would expect their behaviors, with respect to selling their shares of company stock, to coincide with the behavior of other members of top management."[110] The results of the study indicate that "independent directors, along with management, trade (or sell) intensely and earn large abnormal profits on material non-public information during the class period[,]" thereby suggesting that independent directors have been co-opted by management to a large degree.[111]

Given the risk of independent directors being co-opted by management, it would be prudent to give directors exposure to liability. Aside from Section 20(a) liability, potential avenues for imposing liability on directors for their failure to monitor may be insufficient. Excluding Section 20(a), directors are often protected from liability by the business judgement rule, or the need for plaintiffs to make a showing of bad faith.[112] Under the Ninth Circuit's interpretation of Section 20(a), outside directors can be held liable if "they [] have participated in [the company's] operations or exerted 'some influence' therein."[113] In *Peltz v. Polyphase Corp.*, the Ninth Circuit found that the outside director-defendants could be held liable as controlling persons under Section 20(a). While there was no evidence that they participated in the company's day-to-day operations, the court found that the

[108] *Id.*

[109] Enrichetta Ravina & Paola Sapienza, *What do Independent Directors Know? Evidence from Their Trading, 23 REV. FIN. STUD. 962, 963–64 (2010).*

[110] Avci et al., *supra* note 106, at 236.

[111] *Id.*

[112] *Id.* at 281–85.

[113] Peltz v. Polyphase Corp., 36 F. App'x 316, 321 (9th Cir. 2002) (citing Burgess v. Premier Corp., 727 F.2d 826, 832 (9th Cir.1984)).

director-defendants could be held liable because they were aware of, and participated in, the decision to make a filing.[114]

Thus, Section 20(a) can serve as a useful means towards incentivizing gatekeeper behavior among directors in the prevention of possible securities law violations. This conception fits with gatekeeper regimes more generally. In discussing traditional "third-party" gatekeepers such as lawyers and accountants, Assaf Hamdani asserts that such gatekeepers should be held liable "only if they can (1) detect wrongdoing at a reasonable cost, and (2) prevent clients they know to be wrongdoers from committing misconduct."[115] Substituting clients for employees and management for officers and directors, respectively, each would certainly be fit to face liability provided they fail in their duties to gatekeep adequately. As described above officers are in the best position to monitor the day-to-day operations within the company to prevent securities fraud, while directors, particularly outside directors, have the best ability to keep management in check. At least when it comes to preventing federal securities law violations, some of the best placed gatekeepers are officers and directors. Given their suitability for gatekeeping, officers and directors should be held liable not only when they participate in fraudulent schemes, but also in cases when they fail to monitor and induce compliance adequately. In such circumstances, Section 20(a) is a ready-built tool to hold these gatekeepers to account when they fail in their duties.

C. The 9th Circuit Standard will Promote Gatekeeping and Deter Wrongful Behavior

By implementing a widespread judicial interpretation of Section 20(a) that disposes of the culpable participation pleading standard and enforces a strict interpretation of the good faith defense, either through reconsideration by various circuit courts or by Supreme Court decision, courts can enable Section 20(a) to reach its potential of advancing the goals it was drafted to reach and encouraging gatekeeping activities.

[114] *Id.*

[115] Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 99 (2003).

By reaching a standard which forces defendants to have made a reasonable effort to monitor their subordinates and companies for violations, courts can use Section 20(a) as a valuable tool to induce gatekeeping among officers and directors.

i. Discarding Culpable Participation Will Enhance Section 20(a)

The culpable participation pleadings standard does not adhere either to the statutory text or to the legislative intent behind Section 20(a).[116] As defendants are already protected by the affirmative defense of good faith, culpable participation serves only to thwart potentially valid litigation by preventing the plaintiff from reaching discovery.[117] In the Second Circuit, as it currently stands, it may be too difficult for plaintiffs to prove culpable participation prior to discovery. This could allow controlling persons who should indeed be held liable under Section 20(a) to escape liability. The culpable participation requirement has attracted particular attention for its role in prematurely defeating litigation. For example, in *Lapin v. Goldman Sachs* the district court dismissed the plaintiff's Section 20(a) claim on the grounds that they failed to adequately "allege scienter" regarding the defendant's culpable participation.[118]

Having such a litigation-defeating mechanism in place, one that prevents plaintiffs from accessing important information which could only be obtained via discovery, dampens the impact of Section 20(a) in advancing gatekeeper functions among controlling persons. If a controlling person knows that

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[116] *See* discussion *supra* Part II.

[117] *See* Hollinger v. Titan Cap. Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (stating that the burden should be on the defendant to establish their good faith defense); *see also* Brian A. Melhus, *Control Person Liability: A Repudiation of Culpable Participation*, 37 J. CORP. L. 929, 943 (2012) (stating that plaintiffs are often not in a position to meet the burden of proof for culpable participation prior to discovery).

[118] Lapin v. Goldman Sachs Grp., Inc., 506 F. Supp. 2d 221, 248–49 (S.D.N.Y. 2006).

the culpable participation requirement may help them avoid liability, they may be less likely to adequately monitor the behavior of those whom they control. Indeed, controlling persons may be more likely to actually direct violative acts themselves using controlled persons as "dummies" in the exact way Section 20(a) was designed to prevent. For example, district courts within the Second Circuit have dismissed claims for failing to satisfy the culpable participation requirement.[119] If management and directors can easily escape liability by filing a motion to dismiss on the basis that a plaintiff failed in their burden to plead culpable participation, then they have less of an incentive to monitor those they control or to adequately review the work of subordinates.

ii. Good Faith Defense

When culpable participation is dispensed, the burden of proof falls to the defendant in the form of the good faith defense. If good faith refers merely to not participating in or directing wrongdoings, then Section 20(a) would only be useful in preventing controlling persons being engaged in wrongdoing, rather than inducing them to fulfill their duties to monitor their subordinates and to ensure adequate compliance programs are in place. Thus, as discussed in Section II, the good faith defense should be interpreted in such a way that characterizes as a form of recklessness the failure to monitor, put in place compliance programs, or take reasonable steps to evaluate the work product and filings of those whom they control.[120]

[119] McIntire v. China MediaExpress Holdings, Inc., 927 F. Supp. 2d 105, 138 (S.D.N.Y. 2013) ("Plaintiffs contend that 'failure to supervise' satisfies the culpable participation element required under § 20(a). Assuming for the sake of argument that alleging 'failure to supervise' satisfies the culpable participation requirement under § 20(a),12 the Court nevertheless finds that Plaintiffs have failed to adequately allege culpable participation under the heightened pleading requirements of the PSLRA. Plaintiffs plead only general and conclusory allegations . . . .").

[120] *See* discussion *supra* Part II.

iii. Potential Trade Offs and Complications; Overcompliance and Monitoring Costs

While expanding liability to meet or exceed the Ninth Circuit standard could result in enhanced deterrence and monitoring, it could have adverse consequences as well. These unintended effects beg the question whether enhanced liability is the optimal solution. Among these potential adverse consequences are monitoring costs and overcompliance.

Although incentivizing compliance is generally a positive social good, too much deterrence can lead to problems of overcompliance.[121] This can generate inefficiencies and excessive costs.[122] For example, some commentators have cautioned that overdeterrence can possibly "discourage[e] socially-beneficial activity like the disclosure of business related information."[123] Another concern stemming from overcompliance is that officers could have perverse incentives to avoid personal liability at all costs, no matter the consequences to the company. These may include making overly conservative estimates or inundating investors with

[121] *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysi*s, 158 U. PA. L. REV. 2173, 2190–2191 (discussing the trade-offs between deterrence and overcompliance).

[122] *See* Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1683–84 (1996) (referring to the efficiency concerns of overcompliance); *see also The Future of Regulatory Productivity, powered by RegTech*, DELOITTE (2017), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-regulatory-future-of-regulatory-productivity-powered-by-regtech.pdf [https://perma.cc/9BFN-CZN8] ("The cost of compliance and risk mitigation over the last eight years has jettisoned almost all discretionary funding available to firms. Compared to pre-financial crisis spending levels, operating costs spent on compliance have increased by over 60 percent for retail and corporate banks.").

[123] Robert Allen, *Securities Litigation as a Coordination Problem*, 11 U. PA. J. BUS. L. 475, 477 (2009).

unnecessary information.[124] Additionally, the specter of increased liability may dissuade competent individuals from serving in roles in which they could be subject to personal liability.[125]

Finally, the costs of compliance and monitoring may be exacerbated with an increase in potential liability for officers and directors. Firms typically spend more to keep up with regulatory changes such as increased liability and new compliance standards.[126] Such additional cots could include increased spending on directors' and officers' insurance policies.[127] However, it is also possible that adopting more uniform standards in control person liability could lead to less overcompliance by reducing uncertainty.[128]

D. Solutions

124 Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 37–38 (2002)

125 *See* Stacey English & Sussanah Hammond, *Cost of Compliance 2016*, Thomson Reuters 9 (2016), https://archive.comsuregroup.com/wp-content/uploads/2016/07/CostofCompliance_2016.compressed.pdf [https://perma.cc/EN8D-WQUR] ("There has already been a backlash in the United States, where the perceived targeting of compliance officers now risks driving talented individuals out of the industry."); *see also* Ivy Xiying Zhang, *Economic consequences of the Sarbanes–Oxley Act of 2002*, 44 J. OF ACCT. AND ECON. 75, 82 (2007) ("Some commentators allege that SOX increased the difficulty of finding qualified directors . . . ").

126 *See* English & Hammond, *supra* note 125, at 4 ("Good compliance skills have always been at a premium but firms must continue to invest in in-house compliance knowledge and skills; otherwise, they will find it distinctly challenging to implement changes . . . ").

127 *See* Zhang, *supra* note 125, at 82 (referring the directors' and officers' insurance as being a potential cost of Sarbannes-Oxley).

128 *See* David Engstrom, *Private Enforcement's Pathways: Lessons From Qui Tam Litigation*, 114 COLUM. L. REV. 1913, 1935 ("A complicating factor is an influential line of theory suggesting that legal ambiguity is as likely to induce overcompliance as it is undercompliance with regulatory mandates relative to the social optimum.") (citing John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 965 (1984)).

Though adhering to a uniform standard in removing the culpable participation requirement may lead to positive outcomes, including the inducement of greater monitoring behavior among controlling persons, it can also lead to unintended consequences. To avoid these consequences, there are several potential solutions which could allow for a more successful expansion of Section 20(a) liability to induce better gatekeeping. These include delineating clear standards and areas of responsibility and promoting cheap and effective means of monitoring.

i. Clear Standards of Responsibility and Tailoring Liability

One approach to addressing the aforementioned concerns is to demarcate clear standards of conduct for monitoring, as well as clear areas and specific monitoring tasks for which particular parties are responsible as controlling persons. The United Kingdom took such an approach for regulating banks and asset managers. The UK's Certification and Senior Managers Regime "requires firms to allocate prescribed responsibilities to individuals and document the accountabilities in formal 'responsibilities maps.'"[129] This can help to alleviate one of the main causes of overcompliance: uncertainty.[130] Another approach for which one scholar has advocated is "self-tailored liability" for gatekeepers.[131] While Professor Choi's system of self-tailored liability seeks to

[129] *See* English & Hammond, *supra* note 125, at 9.

[130] A lack of clear standards can lead to overcompliance. *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984) ("If the legal standard is uncertain, even actors who behave 'optimally' in terms of overall social welfare will face some chance of being held liable because of the unpredictability of the legal rule. More important, these actors can usually reduce that chance by 'overcomplying,' that is, modifying their behavior beyond the point that would be socially optimal.").

[131] Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 918–19 (1998).

provide an intermediate possibility between purely contractual and strict gatekeeper liability, which may involve an "opt-out" from legal regulation, it could have applications here as well.[132] For example, control persons with specified expertise could have clearly defined duties in monitoring the actions of those they control. Some possibilities could be control persons monitoring certain competencies, sectors, or personnel of the company. This may eliminate some of the problems with expanded Section 20(a) liability, thereby mitigating the uncertainty which can lead to overcompliance.

ii. Cheap and Effective Monitoring

One critique of increased regulation is that monitoring is often not effective.[133] One line of argument states that reforms "rely on increased monitoring by independent directors, auditors, and regulators who have both weak incentives and low-level access to information."[134] With an expansion of control person liability, however, these barriers to effective monitoring may be remedied. An officer covered by Section 20(a) has a strong incentive to monitor the work and actions of their subordinates, as failure to do so could result in liability under federal securities law.[135] Additionally, corporate officers have among any potential monitoring party the greatest knowledge of a business's day-to-day operations.[136] If there is a greater risk of liability for control

[132] *See id.* at 951–52.

[133] *See* Ribstein, *supra* note 124, at 3 ("The frauds [including Enron and other corporate frauds] occurred despite several levels of monitoring by, among others, directors, prominent accounting and law firms, institutional shareholders, debt rating agencies, and securities analyst.").

[134] *Id.*

[135] *See* Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 53 (2003) ("Enhanced liability, however, will also induce gatekeepers to monitor clients and prevent them from committing misconduct.") (while the author was referring to third-party gatekeepers rather than those within the company, the impact of enhanced liability should be the same).

[136] *See* Lisa V. Sison & Brian H. Kleiner, *Differences Between Company Officers and Company Executives*, 24 MGMT. RSCH. NEWS 157, 160 (2001)

persons under a strengthened Section 20(a) regime, officers may be both incentivized to closely monitor the activities of those they control and well placed to do so due to their involvement in the day-to-day management of the company.

CONCLUSION

In addition to remedying wrongs, law at its best can also shape behavior towards socially optimal ends. The Ninth Circuit's approach to Section 20(a) litigation indeed shapes the behavior of controlling persons in such a way. Through the adoption of a more plaintiff-friendly standard, particularly in the Second Circuit, courts can deter officers and directors from using controlled persons as proxies to violate securities laws. Furthermore, they can induce such controlling persons to serve as gatekeepers who monitor for and prevent violations by their agents lest they be held liable under Section 20(a). In doing so, courts would more closely adhere to the language and legislative intent behind Section 20(a).

Additionally, courts should embrace the more expansive version of adequate monitoring and supervision when presented with an affirmative defense of good faith. Such defense makes it more likely that officers and directors who fail in their duties to sufficiently monitor those they control cannot evade liability. In other words, controlling officers and directors are further induced to act as gatekeepers and prevent any securities law violations from taking place. Defendants would be amply protected by the affirmative good faith defense, so a shift towards the more plaintiff-friendly standard would not be likely to wrongly ensnare parties who should not be held liable. Instead, the Ninth Circuit approach would allow valuable litigation to reach discovery. Although excessive monitoring costs and overcompliance may pose problems, delineating clear standards of responsibility for control persons – in addition to other solutions – may mitigate these. In fact, monitoring by officers who are well incentivized

(referring to corporate officers as "[i]nsiders [who] possess rich information about the day-to-day operations . . . . ").

to monitor and who are involved in the day-to-day operations of the company may reduce some monitoring costs.

Therefore, to adhere closer to the legislative history, to allow valuable litigation to reach discovery, and to induce officers and directors to act in a gatekeeping capacity, an interpretation of Section 20(a) liability akin to that of the Ninth Circuit should be widely adopted.