Brunley

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 87-3837

KAY HOLLINGER, et al.,

Plaintiffs-Appellants,

v.

TITAN CAPITAL CORP., et al.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Western District of Washington

SUPPLEMENTAL BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON REHEARING EN BANC, ON THE ISSUE OF RESPONDEAT SUPERIOR LIABILITY

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The Securities and Exchange Commission submits this supplemental brief to respond to the amicus curiae brief of the Securities Industry Association (SIA), which argues that the federal securities laws do not permit the customers of a brokerage firm who have been defrauded by the firm's employees to recover their losses from the firm based on the doctrine of respondeat superior. As the Commission previously noted, this position is at odds with holdings of the other nine federal Courts of Appeals to have considered the issue (SEC Br. 6-7 n.6). We demonstrate below that the specific contentions raised by the SIA are unsupported by the statutory language and legislative history and are contrary to the underlying policies of the federal securities laws.

I. APPLICATION OF THE COMMON LAW DOCTRINE OF RESPONDEAT SUPERIOR TO THE FEDERAL SECURITIES LAWS WOULD FURTHER THE STATUTORY PURPOSE.

The SIA does not dispute that, under other federal statutes, courts properly apply common law doctrines of vicarious liability where to do so "honor[s] the statutory purpose best by interpreting the * * * private cause of action to be at least as broad as plaintiff's right to sue for analogous torts." American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., 456 U.S. 556, 569 (1982). Nevertheless, it contends that this principle does not permit the application of the doctrine of respondeat superior to the federal securities laws.

In its initial brief, the Commission demonstrated that the policies underlying the federal securities laws strongly favor application of the common law doctrine of respondeat superior in the context of the federal securities laws. As noted there (SEC Br. 11), the inability of investors to invoke the doctrine of respondeat superior under the federal securities laws would, notwithstanding Congress' intent to liberalize the common law, actually make the federal securities law more restrictive than actions for common law fraud. In addition, as the Commission has previously shown, recourse to the doctrine of respondeat superior furthers the securities laws' compensatory purpose (SEC Br. 5), protects the legitimate expectations of investors (SEC Br. 6), and encourages compliance with the law. (SEC Br. 4).

In its brief, the SIA takes exception to the view that respondeat superior encourages compliance with the law. It argues (SIA Br. 21-22) paradoxically that application of respondeat will actually undermine the incentive for a firm to maintain adequate compliance and supervisory programs because firms will not derive any "marginal" benefit from undertaking such "good faith" efforts. This argument is flawed. Contrary to the SIA's assertion, firms subject to respondeat superior liability have enormous incentives to undertake precautionary measures to prevent malfeasance by their employees precisely because they are vicariously liable for the conduct of their employees. Firms that are so liable will attempt to minimize their potential liability by diminishing incidents that trigger liability. The principal means for brokerage firms to diminish instances of employee malfeasance is through more effective supervision. Thus, far from eliminating incentives to maintain compliance programs, respondeat superior liability spurs brokerage firms to operate more effective compliance programs. In addition, firms are in the best position to perform this monitoring function. In contrast, investors are without the means, and frequently without the sophistication, to oversee the conduct of the investment professionals whom they turn to for investment services.

The SIA's notion that respondeat superior eliminates firms' incentives to supervise their employees contradicts practical experience. The prevailing legal regime already subjects national brokerage firms to respondeat superior liability in virtually every court of appeals with respect to claims asserted under the federal securities laws and in all states with respect to common law fraud claims. 1/ Yet the SIA provides no evidence that such liability has, in fact, diminished brokerage firms' willingness to maintain compliance programs. The common law doctrine of respondeat superior should not be discarded based on the SIA's strange counterintuitive theory that more liability will result in less supervision.

The SIA also challenges (SIA Br. 22-24) the application of respondeat superior to brokerage firms on grounds of judicial policy because there would be "potentially unmanageable choice-of-law problems for federal courts." As an initial matter, we note that purported choice-of-law problem that is created by application of the doctrine of respondeat superior is not, as the

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1/ While acknowledging that a majority of the courts of appeals have held that respondeat superior is applicable under the federal securities laws, the SIA nevertheless seeks (SIA Br. 6-7 n.3) to raise doubts as to the strength of that authority in certain courts of appeals. Although, as explained in the Commission's initial brief (SEC Br. 7 n.6), use of the doctrine of respondeat superior in federal securities law cases in the Third Circuit is confined to a narrower set of circumstances than in other circuits, that court has unequivocally held that in situations involving accounting firms or, as here, brokerage firms, respondeat superior is applicable because those employers' businesses exert a "strong influence on important investment decisions." See Sharp v. Coopers & Lybrand, 649 F.2d 175, 181-83 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982). Similarly, the SIA relies on a single district court's gloss on controlling Fourth Circuit precedent to argue that one Fourth Circuit panel has reversed the holdings of two others sub silentio. We note that one subsequent district court has expressly disapproved the conclusions set forth in the district court opinion on which the SIA relies. See Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 741-42 (W.D. Va. 1982).

SIA appears to suggest, a matter peculiar either to respondeat superior or the federal securities laws. Yet the SIA has not cited any case that makes choice-of-law considerations a relevant factor for courts to consider in determining whether common law doctrines are available under federal statutes. 2/ Indeed, despite the SIA's misgivings, nine different courts of appeals have applied respondeat superior in one form or another in federal securities law cases and their approach has not precipitated the confusion predicted by the SIA.

Moreover, the SIA's argument is premised on a fundamental misunderstanding of how the common law is applied in non-diversity actions. Federal courts are not, as the SIA asserts (SIA Br. 22), obligated to apply state law in adjudicating respondeat superior claims arising under the federal securities laws, although admittedly state law is a source of law to which federal courts may turn for guidance. 3/ Thus, to the extent

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2/ As discussed above, the Supreme Court has stated that the touchstone for determining whether common law doctrine may be employed in applying a federal statute is whether the common law concept sought to be applied is consistent with the congressional intent which led to enactment of the statute. See American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp., 456 U.S. 556, 569 n. 6 (1982). Presumably the choice of law issue should have militated against the Supreme Court's holding in Hydrolevel, that principles of vicarious liability were applicable to the antitrust laws. That choice of law considerations did not enter into the Supreme Court's analysis suggests that they are equally irrelevant here.

3/ Because this case arises under federal law, it is not controlled by Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938), and state law does not operate of its own force. Burks v.
(continued...)

that federal courts were to encounter difficulties in referring to state law principles in applying respondeat superior, such a factor would merely weigh in favor of federal courts' fashioning a uniform principle of federal common law. In no event would the difficulty hypothesized by the SIA argue against application of a common law doctrine to a federal statute. 4/

3/ (...continued) Lasker, 441 U.S. 471, 476 (1979)(citations omitted). Rather, "[w]hen a federal statute condemns an act as unlawful the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted." Id. at 476 (quoting Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173, 176 (1942)). In deciding what federal law is in this context, a court may look to state law unless its application "would be inconsistent with the federal policy underlying the cause of action," Burks, 441 U.S. at 479 (quoting Johnson v. Railway Express Agency, Inc., 421 U.S. 454, 465 (1975)), or a federal policy requires uniformity. Burks at 479 n.6. See generally C. Wright, A. Miller & E. Cooper, Federal Practice and Procedure § 4515 (1982).

The SIA's reliance on two cases -- Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) and Kerbs v. Fall River Industries, Inc., 502 F.2d 731 (10th Cir. 1974) -- in support of its contention is misplaced. Although in both cases the court looked to state law principles of respondeat superior, neither party appears to have argued that a uniform federal rule would be preferable. We are unaware of any case which has considered whether a uniform federal standard might not be preferable to recourse to state law in applying the doctrine of respondeat superior under the federal securities laws.

4/ The SIA's effort to elevate its concerns to an issue of constitutional import only compounds its confusion. The due process considerations in Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985) stemmed from the application of state law in adjudicating substantive state law rights of non-residents of the state and did not concern, as here, the application of federal law.

II. NEITHER THE LANGUAGE NOR THE LEGISLATIVE HISTORY OF SECTION 20(a) EVIDENCES A CONGRESSIONAL INTENT TO SUPPLANT THE COMMON LAW DOCTRINE OF RESPONDEAT SUPERIOR.

Notwithstanding the strong policy considerations which favor the application of the common law doctrine of respondeat superior to the federal securities laws, the SIA contends (SIA Br. 7-8) that Section 20(a) manifests a clear congressional intent to supplant the common law doctrine of respondeat superior under the Exchange Act. This intent, according to the SIA, is borne out by the language of the statute which, in the SIA's view (SIA Br. 8), establishes "that no controlling person may be held vicariously liable under the 1934 Act where the good faith defense applies." But even a cursory reading of the statute shows that it says no such thing. By its terms, the "good faith" defense recognized in Section 20(a) applies only to liability arising under that section and not to liability arising under other sections of the Exchange Act. Nothing in the section purports to deal comprehensively with vicarious liability under the Exchange Act or to preclude the application of the common law doctrine of respondeat superior. Because Section 20(a) does not on its face address respondeat superior, the language refutes rather than supports the SIA's position.

An even more telling response to the SIA's "plain language" interpretation of Section 20(a) is that it cannot be squared with the recently enacted Section 20A(b)(3), which expressly excludes the use of respondeat superior as a basis for liability in private actions for insider trading by contemporaneous traders while affirming in those actions the applicability of controlling person liability under Section 20(a). 5/ If, as the SIA argues, the controlling person provision in fact supplanted respondeat superior, there would be no reason to distinguish between respondeat superior and controlling person liability as Congress did in Section 20A(b)(3). The SIA asserts (SIA Br. 10 n.4), with reference to the Commodity Exchange Act, that Congress "knew how to write respondeat superior <u>into</u> a statute." But, as is evident from Section 20A(b)(3), Congress is at least equally aware how to write respondeat superior <u>out of</u> a statute. The fact that Congress chose to do so in Section 20A(b)(3) clearly refutes the SIA assumption that, absent a provision providing for respondeat superior, the doctrine of respondeat superior does not apply. In fact, by distinguishing between respondeat superior liability on the one hand and controlling person liability on the other, Congress corroborated the position of the Commission and the majority of the courts of appeals -- respondeat superior applies to claims arising under the federal securities laws, unless Congress expressly directs otherwise.

5/ Section 20A of the Exchange Act, enacted in the Insider Trading and Securities Fraud Enforcement Act of 1988, codifies an express right of action against insider traders on behalf of contemporaneous traders. Section 20A(b)(3) provides:

> CONTROLLING PERSON LIABILITY. -- No person shall be liable under this section solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 20(a) of this title.

Contrary to the SIA's contention (SIA Br. 10), the legislative history of Section 20(a) also supports the Commission's position in that it does not evidence an intent to have the controlling person provision supplant the common law doctrine of respondeat superior. 6/ The comments made by Representative Rayburn, the then-Chairman of the House Committee on Interstate and Foreign Commerce, 7/ are entirely consistent with the Commission's construction of Section 20(a). According to the SIA, however, because Representative Rayburn made reference to "agency," among other forms of legal relationships, in describing the breadth with which "control" would be defined for purposes of Section 20(a), the section should be read as a legislative repudiation of respondeat superior.

A fair reading of Representative Rayburn's remarks demonstrates that his comments cannot bear the substantial weight which the SIA seeks to place on them. The full paragraph in

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6/ The SIA's argument (SIA Br. 9) that the legislative history of Section 20(a) does not reveal an intent to exempt employers from the protection of the good faith defense of Section 20(a) begs the question. The issue in this case is whether Section 20(a) was meant to be the exclusive form of vicarious liability under the federal securities laws. As we demonstrated in our initial brief (SEC Br. 8-11), Congress did not intend controlling person liability to supplant common law doctrines of liability but rather to supplement them. Accordingly, there was no reason for Congress to consider exempting employers from the good faith defense.

7/ The same language appears in the House Report which preceded reconciliation of the House and Senate versions of the Exchange Act. <u>See</u> H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934).

which the quotation appears clearly demonstrates that the reference to "agency" is meant to illustrate one type of control that an affiliate might exercise over another and thus is consistent with the overarching purpose of the section -- preventing circumvention of the Exchange Act's provisions through the use of corporate "dummies." 8/ Representative Rayburn never purported to address employer/employee relationships (although

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8/ The paragraph contained in both the House Report and Representative Rayburn's statement on the floor of the House is as follows:

> In this section and in section 11 [what later was substantially codified as Section 12], when reference is made to "control", the term is intended to include actual control as well as what has been called legally enforceable control. (See Handy & Harman v. Burnet (1931) 284 U.S. 136.) It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation, either by the ownership of such stock alone or through such ownership in combination with other factors.

78 Cong. Rec. 7709 (1934) (daily ed. April 30, 1934 statement of Representative Rayburn); accord H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934).

Nothing about this paragraph is directed specifically at employment relationships involving natural persons. Rather, the principal focus is control exercised over a business entity. The citation to Handy & Harman is to a case involving the relationship between two corporate affiliates. Moreover, the final sentence of the paragraph which immediately follows the reference to agency makes clear that the kind of "control" being discussed is that between a controlling person and the controlled entity rather than the control exercised by an employer over an employee.

it is not disputed that Section 20(a) could be used to affix liability against an employer), much less to deal with the point at issue here, namely whether Section 20(a) was intended to supplant liability pursuant to common law principles of agency. It is inconceivable that Congress would have intended to repeal application of the common law doctrine of respondeat superior _sub silentio_.

In addition to the legislative history cited previously by the Commission (SEC Br. 9 & n.8), other legislative materials underscore this point. As noted in the earlier Commission brief, Section 20(a) was patterned after Section 15 of the Securities Act of 1933. As explained in one of the Conference Statements issued in connection with Congress' deliberations on the Securities Act, the source of the controlling person liability provision in that Act was the Senate bill which had contained provisions "referred to as 'dummy provisions' which were calculated to place liability upon a person who acted through another, _irrespective of whether a direct agency relationship existed_ but dependent upon the actual control exercised by the one party over the other." Conference Statement, 73d Cong., 1st Sess., 77 Cong. Rec. 3902 (1933) (emphasis added). The fact that the control provisions were conceived of as being "irrespective" of agency relationships indicates that the provision as a whole was meant to expand liability beyond then-existing theories of agency law rather than to displace one form of liability with another.

Nor is the Commission's interpretation of Section 20(a), as the SIA contends (SIA Br. 11), "illogical" because employers can be subject to both controlling person liability and respondeat superior while corporate "dummies" are subject only to controlling person liability. The two forms of liability focus on different factors; in the one case, it is the existence of an employer/employee relationship and, in the other, it is the existence of control. The fact that certain defendants may be subject to liability under overlapping theories is hardly "illogical" and occurs in many other areas of the securities laws. Cf. Herman & MacLean v. Huddleston, 459 U.S. 375, 380-87 (1983) (sustaining overlapping remedies under Section 10(b) of the Exchange Act and Section 11 of the Securities Act); SEC v. National Securities, Inc., 393 U.S. 453, 468 (1969) (rejecting a construction of Section 10(b) which would preclude its application to violations which occurred in connection with proxy solicitation notwithstanding the fact that proxy solicitations are directly regulated under Section 14 of the Exchange Act.) 9/

9/ Indeed, as demonstrated by a number of the controlling person/respondeat superior liability cases, courts have frequently found that employers may be liable under the doctrine of respondeat superior and Section 20(a). See, e.g., Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982)(affirming district court decision finding liability against accounting firm under the federal securities laws on respondeat superior and controlling person theories); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980)(holding that district court erred in dismissing federal securities law claims against employer whose employee had defrauded customers since liability could be predicated on either respondeat superior or controlling

(continued...)

Nor does the availability of a good faith defense under the controlling person provision suggest that a comparable defense be made available in cases of respondeat superior liability. Through the controlling person provisions, Congress sought to extend liability to a class of defendants who, unlike employers subject to liability under respondeat superior, were nonetheless in control of the primary wrongdoer. Congress' solution was to formulate a "catchall" controlling person liability provision. Because the breadth of the controlling person provision, and its potential sweep, represented an expansion of liability beyond the common law, defendants were afforded defenses not available to employers. The very different purposes served by the controlling person provision and the common law doctrine of respondeat superior were sufficient in Congress' view to create a special statutory defense for controlling person liability.

9/(...continued)
person liability, even absent a showing sufficient to establish aiding and abetting liability).

CONCLUSION

For the foregoing reasons, including those set forth in the Commission's Brief Regarding Rehearing En Banc, the Commission urges this Court to hold that respondeat superior may be used to establish liability in damage actions under the federal securities laws.

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