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One Statute, **Three Interpretations**, And an Emerging Consensus

Establishing §20(a) control person liability in the Southern District.

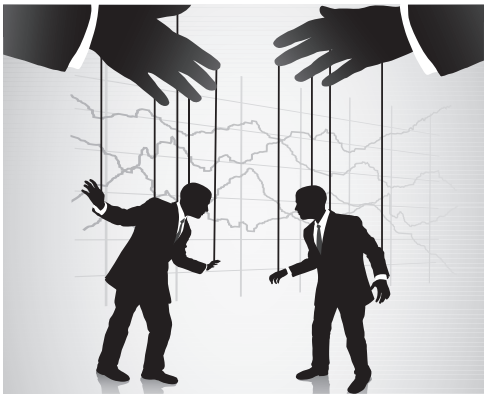
BY MATTHEW T. McLAUGHLIN

PRACTITIONERS in the Second Circuit representing individuals accused of securities law violations know all too well that there is confusion surrounding proving and defending a control person claim under §20(a) of the Securities Exchange Act of 1934. What level of wrongdoing is required before one can be deemed a control person and thereby subjected to the same liability as the primary violator?

For long over a decade, there has been a "lively debate" in the Second Circuit courts as to whether "culpable participation" is an element of a plaintiff's prima facie case. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 558 (SDNY, 2008). As the Second Circuit has yet to squarely answer the issue, a plaintiff's best bet is to plead culpable participation in accordance with Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act (PSLRA). Certainly, it is far easier to allege that a defendant is a control person as opposed to a "culpable" control person, but given the uncertainty in the pleading standard, plaintiffs significantly advance their position if they can allege culpability.

In 1934, Congress passed the Securities Exchange Act to restore confidence in the U.S. securities market and address public outrage that many individuals responsible for the stock market crash of 1929 were insulated from liability through the legal corporate entity. To address the problem, Congress included provisions for "control person liability" in §20(a), providing that

> [e]very person who, directly or indirectly, controls any person liable under any provision of this chapter…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…



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15 U.S.C. §78t(a) (2010). Congress did not define "control," and left to the courts the flexibility to interpret this provision in their best judgment. At the time, it was thought "undesirable to attempt to define the term…[as] it would be difficult if not impossible to enumerate or anticipate the many ways in which actual control may be exerted." H.R. Rep. No. 73-1383, at 26 (1934).

Congress could not possibly have anticipated how true that statement turned out to be. Since 1934, seven circuits have adopted a test for control person liability that requires actual or potential control, but not "culpable participation." On the other hand, in several circuits, including the Fifth and Eleventh circuits, a plaintiff must show that the defendant had both control over the violator and culpably participated in the primary violation. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973). Even within circuits, there is confusion over what a §20(a) plaintiff must allege to state a legally sufficient claim.

The Second Circuit is no exception to this §20(a) phenomenon. As recently as 2007, the Second Circuit stated that, "[t]o establish a prima facie case of control person liability, a plaintiff must show (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." *ATSI Comm. Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 108 (2d Cir. 2007). However, not all courts within the Second Circuit agree on what a plaintiff must plead to establish culpable participation. A discrete minority of judges even dispute whether it is the plaintiff's burden to plead culpable participation, or whether the defendant must instead establish "good faith" as an affirmative defense. Exacerbating this confusion, some other judges have taken no clear position—or have changed positions—since the Second Circuit first clearly articulated the three elements of control person liability. *SEC v. First Jersey Sec. Inc.*, 101 F.3d 1450 (2d Cir. 1996).

This lively debate over what a §20(a) plaintiff must plead may, however, be less animated than originally thought. At least in the Southern District of New York, the large majority of judges now require plaintiffs to apply the PSLRA's heightened pleading requirements to §20(a) claims and to allege particularized facts of the defendant's conscious misbehavior or recklessness. Moreover, since the Second Circuit's ruling in *ATSI Communications* in 2007, only a small fraction of Southern District judges continue to dispute whether "culpable participation" is an element of the plaintiff's prima facie case. The remainder consistently require plaintiffs to plead a level of culpable participation at least approximating recklessness. Thus, while practitioners are well-advised to review their particular judge's most recent opinion on §20(a) before addressing it, the prudent approach to pleading §20(a) claims would assume that particularized facts of the controlling person's conscious misbehavior or recklessness are required.

The 'Culpable Participation' Element

While the words "culpable participation" do not appear anywhere in the text of §20(a), in

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1973, the Second Circuit interpreted §20(a) to "impose liability only on those directors who fall within its definition of control *and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons*." *Lanza*, 479 F.2d at 1299 (emphasis added). The following year, the court reiterated the "culpable participation" requirement, reversing a judgment of §20(a) liability for insufficient evidence that the defendant had "knowledge of the fraudulent representations or in any meaningful sense culpably participated in them." *Gordon v. Burr*, 506 F.2d 1080, 1086 (2d Cir. 1974).

By 1980, however, the Second Circuit seemingly departed from its previous rulings and held that allegations of control coupled with an underlying primary violation were, without more, sufficient to state a §20(a) claim. See *Marbury Mgmt. v. Kohn*, 629 F.2d 705 (2d Cir. 1980). Thereafter, courts in the Second Circuit, and the Southern District in particular, were deeply divided over whether §20(a) required plaintiffs to establish a defendant's culpability, or whether a defendant was required to establish "good faith" as an affirmative defense.

This intra-circuit debate came to a head in 1996, when the Second Circuit attempted to reconcile its prior precedent by holding that:

> [i]n order to establish a prima facie case of controlling-person liability, a plaintiff must show [1] a primary violation by the controlled person…[2] control of the primary violator by the targeted defendant, and… [3] that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person.

First Jersey, 101 F.3d at 1472 (citations and quotation marks omitted). Since then, each time the Second Circuit has revisited the elements of §20(a) liability, it has reiterated this now familiar three-prong test.

Persistent 'Lively Debate'

While many courts in the Southern District interpreted *First Jersey* to require that plaintiffs plead a defendant's culpable participation, others persisted in imposing on the defendant the burden of proving his own "good faith" or, basically, the absence of culpable participation. These courts found ambiguity in the Second Circuit's holding that a plaintiff must "show" (as opposed to plead) culpable participation and observed that "whenever the Second Circuit has *applied* its own test, it has essentially rendered the culpable participation requirement meaningless." *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 392-98 (S.D.N.Y. 2003) (Scheindlin, J.). Even judges who ultimately accepted culpable participation as an element of the plaintiff's prima facie case have acknowledged that "[t]he holding that Section 20(a) has no scienter [or culpable participation] element is…commanded" by the text of §20(a) and Congressional intent. See *In re Initial Public Offering*, 241 F. Supp. 2d at 394-95; accord *Lapin v. Goldman Sachs Group Inc.*, 506 F. Supp. 2d 221, 247-48 (S.D.N.Y. 2006) (Karas, J.). However, as Judge Kenneth M. Karas of the Southern District keenly observed, "the Second Circuit has spoken and…until [it] holds otherwise, some level of culpable participation… must be alleged to state a §20(a) claim." *Lapin*, 506 F. Supp. 2d at 248.

At least quantitatively, the large majority of Southern District judges agree with Judge Karas. Since the Second Circuit's ruling in *ATSI Communications*, only two out of the 36 judges currently eligible to hear cases in the Southern District have consistently held that culpable participation is not an element of the plaintiff's prima facie case. See, e.g., *Berks Cnty. Emp. Ret. Fund v. First Am. Corp.*, 734 F. Supp. 2d 533, 537 (S.D.N.Y. 2010) (Kaplan, J.); *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 558 (S.D.N.Y. 2008) (Kaplan, J.); *Vladimir v. Bioenvision Inc.*, 606 F. Supp. 2d 473, 496 (S.D.N.Y. 2009) (Stein, J.). Of the remaining 34 judges, at least 24 have restated and/or applied *First Jersey*'s familiar three-prong test in the context of a defendant's motion to dismiss a §20(a) claim for failure to state a claim.

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Additionally, among the judges in the Southern District who require §20(a) plaintiffs to plead culpable participation, most agree that a plaintiff must meet the heightened pleading requirements of the PSLRA and must allege particularized facts showing the defendant's conscious misbehavior or recklessness. A few, however, permit notice pleading under Rule 8(a), concluding that "allegations of control are not averments of fraud and therefore need not be pleaded with particularity." *Sgalambo v. McKenzie*, 739 F. Supp. 2d 453, 474 (S.D.N.Y. 2010) (Scheindlin, J.) (citations and quotation marks omitted); accord *In re Smith Barney Trans. Agent Litig.*, No. 05 Civ. 7583(WHP), 2011 WL 350289 (S.D.N.Y. Jan. 25, 2011) (Pauley III, J.). These judges appear to collapse the control and culpable participation elements into a single inquiry, or else equate culpable participation with actual control over the transaction in question—two positions from which other Southern District judges have solidly retreated.

What level of wrongdoing is required before one can be deemed a control person and thereby subjected to the same liability as the primary violator? To be safe, plaintiffs should plead particularized facts showing the defendant's conscious misbehavior or recklessness to satisfy §20(a). If such facts are unavailable, however, emphasizing the nature or degree of the defendant's control over the primary violator, as well as the obviousness of the primary violation, can blur the line between conscious misbehavior or recklessness (which satisfy the PSLRA's heightened pleading requirements) and ordinary negligence (which does not).

Finally, as some Southern District judges have wavered over whether a plaintiff must plead control person liability in accordance with Rule 8(a) or Rule 9(b) and the PSLRA, it is still possible for a plaintiff without particularized facts to persuade his or her judge that particularized facts are not required to withstand a motion to dismiss. Compare *In re Fannie Mae 2008 Sec. Litig.*, 742 F. Supp. 2d 382, 415 (S.D.N.Y. 2010) (Crotty, J.) ("Control person liability need not be pleaded with particularity and is generally analyzed under the 'short and plain' statement analysis of Rule 8(a)"), with *Police and Fire Retirement Sys. of Detroit v. Safenet Inc.*, 645 F. Supp. 2d 210, 227 (S.D.N.Y. 2009) (Crotty, J.) ("The PSLRA's heightened pleading standards apply to Section 20(a) claims").

Conclusion

Thus, since at least 2007, the so-called "lively debate" over what a plaintiff must plead to establish control person liability under §20(a) is substantially less animated than is sometimes suggested. A strong consensus has emerged requiring §20(a) plaintiffs to not only plead culpable participation, but to do so in accordance with the PSLRA's heightened pleading requirements and allege particularized facts of the defendant's conscious misbehavior or recklessness. As for those plaintiffs who cannot allege such particularized facts, the solution is cold comfort: hope that your case is assigned to a judge who adheres to the minority position that plaintiffs can establish "culpable participation" by pleading in accordance with Rule 8(a), or hope that your case is assigned to a judge who does not require plaintiffs to plead culpable participation at all. Otherwise, review your particular judge's §20(a) jurisprudence to see whether the culpable participation requirement is indeed as "meaningless" as some Southern District judges suggest. Until the Second Circuit answers definitively whether and to what extent a plaintiff must plead "culpable participation," this small amount of ambiguity is a fact-deficient plaintiff's best bet.

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