New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

Web address: http://www.nylj.com

VOLUME 239—NO. 112 WEDNESDAY, JUNE 11, 2008 ALM

Corporate and Securities Litigation

BY SARAH S. GOLD AND RICHARD L. SPINOGATTI

Parent Firm Damages Fixed for Control Person Liability

In a matter of first impression, the U.S. Court of Appeals for the Eleventh Circuit has clarified the effect of §21(D)(f) of the Private Securities Litigation Reform Act of 1995 (PSLRA), which provides for proportional liability for damages in certain circumstances, on control person claims under §20(a) of the Securities Exchange Act of 1934. *Laperriere v. Vesta Insurance Group Inc.*, 2008 WL 1883482 (11th Cir. April 30, 2008).

Rejecting the argument that §21(D)(f) had no application at all to §20(a) claims as well as the possibility that it completely supplanted the §20(a) liability standard, the Eleventh Circuit held that §21(D)(f) altered the ultimate allocation of damages for a control person found liable but did not change the basic standard for liability under §20(a).

Although the decision was issued in the specific context of limiting the exposure of a parent corporation's control person liability for acts of a subsidiary to a proportionate share of the damages rather than joint and several responsibility for all damages, it is equally applicable to any control person claim. The decision is especially noteworthy and important, however, because it limits the potential vicarious liability of a parent corporation for securities violations of its subsidiaries, and will be particularly welcomed by the business world, especially in light of the increasing transnational footprint of public companies.

Background

Section 20(a) of the Exchange Act creates derivative liability for any legal person (including a corporate entity) who "controls" the primary violator. It states:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. 15 U.S.C. §78t(a).

Sarah S. Gold *is a partner and* **Richard L. Spinogatti** *a senior counsel at Proskauer Rose.* **Karen E. Clarke,** *an associate at the firm, assisted in the preparation of this article.*


Sarah S. Gold *Richard L. Spinogatti*

The Exchange Act does not define "control." The Securities and Exchange Commission (SEC) and the courts have devised varying tests, which focus upon the "power to control" and/or "actual control," in what is agreed to be a fact-dependent inquiry. *Laperriere*, 2008 WL 1883482 at *4-5 & nn. 13, 14. Even if the §20(a) defendant meets the control-person test, the defendant may escape liability entirely by establishing the statutory defense that the defendant "acted in good faith" and "did not directly or indirectly induce" the primary violator's illegal act. Id. at *5.[1]

Traditionally, pre-PSLRA, all defendants who were found liable in securities cases were jointly and severally liable for all the plaintiff's damages. Thus, a defendant who was far less culpable than others, but who had a "deep pocket," might have been forced to pay all the damages. To mitigate that inequity, Congress established a proportionate liability scheme in the PSLRA that mandates joint and several liability only against those who "knowingly commit" a violation of the Act. Id. at *2. Specifically, §21(D)(f), titled "Proportionate liability," states in part:

> (2) Liability for damages
>
> (A) Joint and several liability
>
> Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.
>
> (B) Proportionate liability
>
> (i) In general
>
> Except as provided in subparagraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined [by the fact finder]. 15 U.S.C. §78u-4(f)(2).

Congress also specifically stated, in subdivision (1) of this provision, titled "Applicability":

> Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws. Id. §78u-4(f)(1).

The 'Laperriere' Decision

Laperriere was a securities class action against Vesta Insurance Group, its former parent company, Torchmark Corp., its outside auditors, and several individuals. 2008 WL 1883482 at *1. The §20(a) claim against Torchmark alleged that it had been a controlling person of alleged primary violator Vesta. All defendants settled except Torchmark. Plaintiffs moved to strike certain of Torchmark's affirmative defenses that invoked the proportionate liability scheme of §21(D)(f). Plaintiffs argued that controlling person liability is governed by §20(a), which provides for joint and several liability, and not by §21(D)(f), which plaintiffs asserted had no application at all to control persons. Id. The district court denied plaintiffs' motion in 2003, holding that the PSLRA provision governs whether Torchmark, if found liable, would be subject to joint and several or proportionate liability. In 2006, after further proceedings brought the case closer to trial, the district court certified the 2003 decision for interlocutory appeal, posing the question "whether, and to what extent, the proportionate liability scheme of section 21(D)(f)…amends section 20(a)." Id.

The Eleventh Circuit affirmed, holding that §21(D)(f)'s proportionate liability provision could apply to the §20(a) claim against Torchmark. Id. at *1, 10. Declining to find that §21(D)(f) had implicitly repealed §20(a), the court emphasized that the two sections "should be read in harmony to preserve both the PSLRA's proportionate liability scheme and a controlling person's derivative liability under section 20(a)." Id. at *1.

The Eleventh Circuit first analyzed whether §21(D)(f)'s proportionate liability provision can apply to a §20(a) claim at all, and held that it does. Id. at *7. Section 21(D)(f) applies to "[a]ny covered person," which means any defendant in any private action arising under chapter 2B of title 15 of the U.S. Code. Since §20(a) is found in that chapter, any §20(a) defendant is a covered person subject to §21(D)(f). Id.

The court next addressed whether the PSLRA "amends" the joint and several liability provision of §20(a), and held that it does not. The court observed that subsection (1) of §21(D)(f) makes clear that nothing in the proportionate liability provisions affects or modifies the "standard for liability" under the securities laws, which include §20(a). Id. Under §20(a), persons who control others who commit securities fraud will be jointly and severally liable unless they can establish the affirmative defense of good faith and lack of inducement. Thus the plain meaning of the statute is that if controlling person liability existed before the PSLRA, it still exists afterward. Id. The court explained that this conclusion is bolstered by the PSLRA's legislative history. The committee report indicated that the new proportionate liability provision was not intended to expand or diminish the substantive standard for liability in any securities action, and would apply solely to the allocation of damages. Id. at *8.

Therefore, the Eleventh Circuit concluded, §21(D)(f) simply sets a new standard for allocating damages in the event that a party is found liable as a controlling person. If §20(a) liability is found, to determine whether the controlling person is responsible for the entire amount of damages or only a proportionate share, one looks to the §21(D)(f) provisions just as for all "covered persons." Id. at *8. Under these provisions, there will be joint and several liability for all the damages only if the fact finder determines that the controlling person "knowingly committed" the violation. Where a controlling person fails to establish the statutory defense of good faith and noninducement under §20(a), but the violation was not "knowing," the responsibility for the damages is only proportionate. Id. (citing 15 U.S.C. §78u-4(f)(2)(A), (B)(i)). Again, the court noted, this reading of the plain language is consistent with the legislative history, which reflected a concern about strike suits being brought against defendants who have done nothing wrong but are seen as having deep pockets. Id. at *9.

Finally, the court observed, to read §21(D)(f) to exclude controlling persons from the proportionate liability provisions, as plaintiffs urged, would lead to an untenable result: the controlling person could be responsible for more of the damages than the primary violator itself. This could arise if both the controlling party and the primary violator acted recklessly instead of knowingly. Recklessness might make the controlling person ineligible for the good faith affirmative defense of §20(a) and, if §21(D)(f) were inapplicable, that controlling person would be jointly and severally responsible for damages. However, the primary violator, obtaining the benefit of §21(D)(f), would escape joint and several damages because it did not act knowingly. Id. at *9. Such a result, treating controlling persons more harshly than primary violators, "would be contrary to common sense, to what the committee that drafted the PSLRA said it intended to do, and to what Congress actually did in the plain language of the PSLRA." Id. at *10. The plaintiffs' effort to deny Torchmark the benefit of the PSLRA standard thus correctly failed.

'Knowing' Violations

The Eleventh Circuit's analysis is straightforward as a matter of statutory construction, and the court did not go beyond the limited certified question. Thus, the court did not address the interesting issue of what would be needed to show that a corporate controlling person, like Torchmark, "knowingly committed" a violation of the securities laws to trigger the joint and several damages obligation. Under §21(D)(f), a person "knowingly commits a violation of the securities laws" if it (1) "makes an untrue statement of a material fact, with actual knowledge that the representation is false" or (2) "omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that …one of the material representations of the covered person is false" or (3) "engages in…conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws." 15 U.S.C. §78u-4(f)(10)(A).

'Actual Knowledge' Standard

The "actual knowledge" standard raises the question of which corporate agent(s) must possess that knowledge. Must it be the same individual(s) who exercises or possesses the controlling power that made the corporation into a controlling person in the first place? In the context of direct §10(b) liability, several circuit courts have rejected the notion of a "collective corporate scienter" in which the knowledge and actions of separate corporate agents may be pooled, and instead require that the scienter must inhere in the same individual(s) who made the misstatement or directed its issuance.[2] If primary liability cannot be placed upon a corporation when one agent's knowledge is disconnected from another agent's conduct, then derivative control person liability should not be imputed to a corporation on a similarly disconnected basis. In any event, such an analysis is unlikely to arise because if sufficient evidence of a controlling person's knowing misconduct exists, that defendant would be charged as a primary violator.

Conclusion

Because there can be no §20(a) claim in the absence of a valid primary claim, most control person claims are dismissed or settled together with the primary claims rather than being separately litigated to the point of damages assessment. Consequently, the control person's ultimate liability for damages is an issue infrequently addressed, and it is not surprising that the PSLRA's applicability has only now been first decided. In the context of parent/subsidiary control, the issue will be of consequence where, as in *Laperriere*, the control relationship has been severed or where a subsidiary is in financial difficulty or bankruptcy. The *Laperriere* decision removes securities plaintiffs' ability to name a deep-pocket parent corporation as a defendant to hold over its head the threat of liability for joint and several damages, absent quite unusual circumstances of "knowing" misconduct.

As a practical matter, the effect of this decision is that liability resulting from a parent corporation's §20(a) control of a subsidiary is now limited to proportionate damages. In that regard, the decision continues the current direction of Congress and the federal courts towards stricter standards in private class action securities litigation.

1. While in most circuits the good faith/noninducement exception is viewed as an affirmative defense to be proved by the defendant, in the Second Circuit the plaintiff is usually required to plead the defendant's "culpable participation." See *Kalin v. Xanboo Inc.*, 526 F.Supp.2d 392, 406-07 (S.D.N.Y. 2007).

2. See *Pugh v. Tribune Co.*, 521 F.3d 686, 697 (7th Cir. 2008); *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004); *Nordstrom Inc. v. Chubb & Son Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995). For a discussion of the conflicting views within the Second Circuit, see our article in this column on Aug. 9, 2006, "Guidance Sought on Pleading Corporate Scienter."